

No. 16341 ✓

VOL 3105

United States
Court of Appeals
for the Ninth Circuit

JOE L. SCHMITT, JR., and HELEN M.
SCHMITT,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court
of the United States

FILED

NOV 16 1959

PAUL P. O'DRISCOLL, CLERK



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Court of Appeals
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES

ROBERT ASH,
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Washington 6, D. C.,
For the Petitioners.

CHARLES K. RICE,
Asst. U. S. Attorney General;

LEE A. JACKSON,
Atty., Dept of Justice,
Dept. of Justice,
Washington, D. C.,
For the Respondent.

The Tax Court of the United States

Docket No. 60267

JOE L. SCHMITT, JR., and HELEN M.
SCHMITT, Husband and Wife,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Ap:LA:AA-EWM 90D-FNG), dated September 2, 1955, and, as a basis of this proceeding, allege as follows:

I.

Petitioners are husband and wife whose residence address is 8540 North Central Avenue, Phoenix, Arizona. The returns for the years here involved were filed with the Collector of Internal Revenue, Phoenix, Arizona.

II.

The notice of deficiency, a copy of which is attached hereto and made a part hereof by reference, is dated September 2, 1955.

III.

The tax in controversy is income tax for the calendar years 1949, 1950 and 1951 in the total

amount of \$12,032.56, the detail of which is as follows:

Year	Deficiency
1949	\$ 31.44
1950	9,357.72
1951	2,643.40
<hr/>	
Total	\$12,032.56

IV.

The determination of tax set forth in the said notice of deficiency is based upon the following errors:

1. The Commissioner erred in increasing 1949 income in the amount of \$9,465.02 on account of "adjustment of deduction for medical expenses."

2. The Commissioner erred in increasing 1949 income in the amount of \$9,465.02 on account of "adjustment of ordinary income from contracts covering Exact-O-Matic franchises."

3. The Commissioner erred in increasing 1950 income in the amount of \$2,268.20 on account of "elimination of a deduction for tabulating machine rental."

4. The Commissioner erred in increasing 1950 income in the amount of \$458.99 on account of "adjustment of deduction for medical expenses."

5. The Commissioner erred in increasing 1950 income in the amount of \$44,500 on account of "ad-

justment of ordinary income from contracts covering Exact-O-Matic franchises.”

6. The Commissioner erred in increasing 1951 income in the amount of \$2,008.87 on account of “disallowance of deduction for repairs to two houses.”

7. The Commissioner erred in increasing 1951 income in the amount of \$480.89 on account of “adjustment of deduction for medical expenses.”

8. The Commissioner erred in increasing 1951 income in the amount of \$12,800 on account of “adjustment of ordinary income from contracts covering Exact-O-Matic franchises.”

V.

The facts upon which the petitioners rely as the basis for this proceeding are:

1. The taxpayer, Joe L. Schmitt, Jr., is the inventor and sole owner of patents, patents pending, copyrights and registrations referred to under the trade name “Exact-O-Matic System.” The System is an accounting method, described as being an automatic mechanical process, utilizing tabulating cards to evaluate single entry information, which produces double entry bookkeeping and accounting statements.

2. During each of the years 1949, 1950 and 1951 Joe L. Schmitt, Jr., entered into a series of contracts of sale with various persons whereby they purchased all assets owned by petitioner and em-

bodied in the "Exact-O-Matic System," within certain specified geographical areas in the United States.

3. During each of the years 1949, 1950 and 1951, the purchasers of the territorial rights, referred to in paragraph (2) hereof, paid to the petitioners as part or all of the purchase price of the said contracts, the sums of \$9,465.02, \$45,500 and \$12,800, respectively.

4. In their income tax returns for the years 1949, 1950 and 1951 the taxpayers treated the amounts of \$9,465.02, \$45,500 and \$12,800, respectively, as consideration for the sale of long-term capital assets.

5. The Commissioner, in his notice of deficiency, determined that the payments referred to in the preceding paragraph represented ordinary income and not proceeds from the sale of capital assets.

6. Under the terms of the contracts of sale referred to in paragraph 2 hereof, Joe L. Schmitt, Jr., trading as Exact-O-Matic System, was required to provide training, at his expense for the personnel of the purchasers who would operate the system. The Exact-O-Matic System, Inc., a corporation, operating the Exact-O-Matic System of bookkeeping in the Phoenix, Arizona, area, contracted with Joe L. Schmitt, Jr., to furnish this training and, accordingly, Exact-O-Matic System, Inc., utilized the bookkeeping machines rented from Remington-Rand in this training.

7. The taxpayer, Joe L. Schmitt, Jr., entered into an agreement with Exact-O-Matic System, Inc., whereby Joe L. Schmitt, Jr., paid a portion of the machine rental because of the utilization of the Remington-Rand machines referred to in the preceding paragraph. In the calendar year 1950 the petitioner paid the amount of \$2,268.20 as his portion of the expense incurred in the rental of the Remington-Rand machines used to train the personnel.

8. In their tax return for the year 1950, the taxpayers deducted this amount as an ordinary and necessary business expense.

9. The Commissioner, in his notice of deficiency, determined that the payment referred to in the preceding paragraphs is not deductible as an expense of the taxpayers.

10. In December, 1951, the taxpayers purchased two houses which had been used for rental purposes and which use the taxpayers intended to continue. The taxpayers were compelled to make certain repairs to the said houses in the amount of \$2,008.89.

11. In their tax return for the year 1951, the taxpayers deducted the amount of \$2,008.89 as an ordinary and necessary business expense incurred in the repair of property held for rental.

12. The Commissioner, in his notice of deficiency, determined that repairs to the two houses represented a capital expenditure.

13. The taxpayers deducted the amounts of \$479.22, \$458.99 and \$480.89 in the years 1949, 1950 and 1951, respectively, for medical expenses.

14. The Commissioner increased the adjusted gross income of the petitioners in each of the years 1949, 1950 and 1951, resulting in a disallowance of medical expenses in the amounts of \$275.57, \$458.99 and \$480.89, respectively.

Wherefore, the petitioners pray that this Court may hear the proceeding and:

1. Determine that the Commissioner erred in increasing 1949 income in the amount of \$275.57 on account of "adjustment of deduction for medical expenses."

2. Determine that the Commissioner erred in increasing 1949 income in the amount of \$9,465.02 on account of "adjustment of ordinary income from contracts covering Exact-O-Matic franchises."

3. Determine that the Commissioner erred in increasing 1950 income in the amount of \$2,268.20 on account of "elimination of a deduction for tabulating machine rental."

4. Determine that the Commissioner erred in increasing 1950 income in the amount of \$458.99 on account of "adjustment of deduction for medical expenses."

5. Determine that the Commissioner erred in increasing 1950 income in the amount of \$44,500 on account of "adjustment of ordinary income

from contracts covering Exact-O-Matic franchises.”

6. Determine that the Commissioner erred in increasing 1951 income in the amount of \$2,008.87 on account of “disallowance of deduction for repairs to two houses.”

7. Determine that the Commissioner erred in increasing 1951 income in the amount of \$480.89 on account of “adjustment of deduction for medical expenses.”

8. Determine that the Commissioner erred in increasing 1951 income in the amount of \$12,800 on account of “adjustment of ordinary income from contracts covering Exact-O-Matic franchises.”

9. Grant such other and further relief as the Court may deem proper.

/s/ ROBERT ASH,

Attorney for Petitioners.

Duly verified.

U. S. Treasury Department
Internal Revenue Service
Regional Commissioner
1250 Subway Terminal Building
417 South Hill Street
Los Angeles 13, California

Sept. 2, 1955.

In Replying Refer to:

Ap:LA:AA-EWM

90D:FNG.

Mr. Joe L. Schmitt, Jr., and
Mrs. Helen M. Schmitt,
Husband and Wife,
8540 North Central Avenue,
Phoenix, Arizona.

Dear Mr. and Mrs. Schmitt:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1949; December 31, 1950, and December 31, 1951, discloses deficiencies in tax aggregating \$12,032.56, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiencies. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise, Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute, in duplicate, the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, 1250 Subway Terminal Building, 417 South Hill Street, Los Angeles 13, California. The signing and filing of this form will expedite

the closing of your returns by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earliest.

Very truly yours,

T. COLEMAN ANDREWS,
Commissioner of Internal
Revenue;

By,
Associate Chief, Appellate
Division.

Enclosures:

Statement.

Form 1276.

Agreement Form.

Ap :LA :AA-EWM
90D-FNG

Statement

Joe L. Schmitt, Jr., and Helen M. Schmitt,
(Husband and Wife),
8540 N. Central Avenue,
Phoenix, Arizona.

Tax Liability for the Taxable Years Ended December 31, 1949,
December 31, 1950, and December 31, 1951

Year	Deficiency
1949 Income Tax	\$ 31.44
1950 Income Tax	9,357.72
1951 Income Tax	2,643.40
Totals	<hr/> \$12,032.56

In making this determination of your income tax liability, careful consideration has been given to your protest dated June 14, 1954, and to the statements made at the conferences held on November 19, 1954, and July 29, 1955.

A copy of the letter and a copy of this statement have been mailed to your representative, Mr. Robert Ash, 1921 Eye Street, N.W., Washington 6, D. C., in accordance with the authority contained in the power of attorney executed by you.

Year 1949

Adjustment to Net Income

Net income as disclosed by the return		
(Loss)		(\$ 797.68)
Unallowable deduction and additional income:		
(a) Adjustment of interest income	\$ 27.49	
(b) Adjustment of deduction for medical expenses	275.57	
(c) Adjustment of ordinary income from contracts covering Exact-O-Matic franchises	9,465.02	9,768.08
	<hr/>	<hr/>
Total		\$8,970.40
Nontaxable income and additional deductions:		
(d) Elimination of long-term capital gain on sales of Exact-O-Matic franchises		3,981.02
		<hr/>
Net income as revised		\$4,989.38

Explanation of Adjustments

(a) It has been determined that interest of \$27.49 earned on a savings account was omitted from your return.

(b) Your net income is increased \$275.57, representing disallowance of deduction for medical expenses. Computation of adjustment is shown below:

Total medical expenses \$523.47

Adjusted gross income as shown by the return	\$ 884.90
--	-----------

Add:

Net increase in income due to considering gain on sales of Exact-O-Matic franchises as ordinary income in lieu of long-term capital gain	\$5,484.00
--	------------

Increase in interest income	27.49	5,511.49
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Adjusted gross income as revised	\$6,396.39
--	------------

Total medical expenses.....	\$523.47
-----------------------------	----------

Less:

5% of adjusted gross income as revised of \$6,396.39..	319.82
--	--------

Allowable deduction for medical expenses.....	\$203.65
---	----------

Deduction for medical expenses claimed in your return....	479.22
---	--------

Increase in net income.....	\$275.57
-----------------------------	----------

(c) Your net income is increased \$9,465.02, representing adjustment of ordinary income from the contracts covering Exact-O-Matic franchises. Computation of adjustment is shown below :

Selling price of Exact-O-Matic franchises shown by your return.....	\$7,965.02
---	------------

Sales of franchises omitted from your return.....	1,500.00
---	----------

Ordinary income from sales of Exact-O-Matic franchises	\$9,465.02
--	------------

Ordinary income from sales of Exact-O-Matic franchises as shown by the return.....	None
--	------

Increase in net income.....	\$9,465.02
-----------------------------	------------

(d) Your net income is decreased \$3,981.02, representing elimination of capital gain reported in your return from sales of Exact-O-Matic franchises.

Income from the contracts covering Exact-O-Matic franchises is held to be ordinary income in lieu of capital gain as reported in your return.

(Year 1949)

Computation of Tax

Net income	\$4,989.38
Less: 8 exemptions at \$600.00 each.....	4,800.00
<hr/>	
Income subject to tentative tax.....	\$ 189.38
One-half of income subject to tentative tax.....	\$ 94.69
Tentative tax on \$94.69.....	\$ 18.94
Less: 17% of \$18.94.....	3.22
<hr/>	
Balance	\$ 15.72
Total income tax—twice the above balance.....	\$ 31.44
Correct income tax liability.....	\$ 31.44
Income tax liability disclosed by the return, Account No. 8560595, Arizona District.....	None
<hr/>	
Deficiency in income tax.....	\$ 31.44

(Year 1950)

Adjustment to Net Income

Net income as disclosed by the return....	\$ 7,478.65
Unallowable deduction and additional income:	
(a) Adjustment of interest income....	\$ 12.74
(b) Elimination of deduction for tabulating machine rental.....	2,268.20
(c) Adjustment of deduction for medical expenses	458.99
(d) Adjustment of ordinary income from contracts covering Exact- O-Matic franchises	44,500.00
	47,239.93
<hr/>	
Total	\$54,718.58
Nontaxable income and additional deductions:	
(e) Elimination of long-term capital gain on sales of Exact-O-Matic franchises	17,057.50
<hr/>	
Net income as revised.....	\$37,661.08

Explanation of Adjustments

(a) It has been determined that interest of \$12.74 earned on a savings account was omitted from your return.

(b) It has been determined that expense of \$2,268.20 incurred for the rental of tabulating equipment is deducted by the Exact-O-Matic System, Inc.; therefore the deduction of \$2,268.20 claimed in your return is being disallowed.

(c) Your net income is increased \$458.99, representing disallowance of deduction for medical expenses. Computation of adjustment is shown below:

Total medical expenses.....		\$ 1,063.24
Adjusted gross income as shown by the return		\$ 9,759.99
Add:		
Net increase in income due to consider- ing gain on sales of Exact-O-Matic franchises as ordinary income in lieu of long-term capital gain.....	\$27,442.50	
Increase in interest income.....	12.74	
Disallowance of deduction for rental of tabulating machine equipment.....	2,268.20	29,723.44
Adjusted gross income as revised.....		\$39,483.43
Total medical expenses.....		\$ 1,063.24
Less: 5% of adjusted gross income as revised of \$39,483.43.....		1,974.17
Allowable deduction for medical expenses.		None
Deduction for medical expenses claimed in your return.....		458.99
Increase in net income.....		\$ 458.99

(d) Your net income is increased \$44,500.00, representing adjustment of ordinary income from contracts covering Exact-O-Matic franchises. Computation of adjustment is shown below:

Selling price of Exact-O-Matic franchises shown by your return.....	\$45,500.00
Less: Fees paid for promoting sale of franchises in the State of Georgia.....	1,000.00
	<hr/>
Ordinary income from sales of Exact-O- Matic franchises	\$44,500.00
Ordinary income from sales of Exact- O-Matic franchises as shown by the return	None
	<hr/>
Increase in net income.....	\$44,500.00

(e) Your net income is decreased \$17,057.50, representing elimination of capital gain reported on your return from sales of Exact-O-Matic franchises.

Income from the contracts covering Exact-O-Matic franchises is held to be ordinary income in lieu of capital gain as reported in your return.

Computation of Tax

Net income	\$37,661.08
Less: 8 exemptions at \$600.00 each.....	4,800.00
	<hr/>
Income subject to tentative tax.....	\$32,861.08
One-half of income subject to tentative tax	\$16,430.54
Tentative tax on \$16,430.54.....	\$ 5,415.27
Less: 13% of \$400.00.....\$ 52.00	
9% of \$5,015.27..... 451.37	503.37
	<hr/>
Balance	\$ 4,911.90
Total income tax—twice the above balance	\$ 9,823.80
Correct income tax liability.....	\$ 9,823.80
Income tax liability disclosed by the return, Account No. 9080516, Arizona District	466.08
	<hr/>
Deficiency in income tax.....	\$ 9,357.72

(Year 1951)

Adjustment to Net Income

Net income as disclosed by the return.....		\$ 7,042.03
Unallowable deduction and additional income:		
(a) Adjustment of interest income.....	\$ 1.41	
(b) Disallowance of deduction for repairs to two houses.....	2,008.87	
(c) Adjustment of deduction for medical expenses	480.89	
(d) Adjustment of ordinary income from contracts covering Exact-O-Matic franchises	12,800.00	15,291.17
	<hr/>	<hr/>
Total		\$22,333.20
Nontaxable income and additional deductions:		
(e) Elimination of long-term capital gain on sales of Exact-O-Matic franchises		4,888.00
		<hr/>
Net income as revised.....		\$17,445.20

Explanation of Adjustments

(a) It has been determined that interest of \$1.41 earned on a savings account was omitted from your return.

(b) It has been determined that repairs to two houses in the amount of \$2,008.87 represent a capital expenditure, and the expense deduction claimed in your return in the amount of \$2,008.87 is therefore disallowed.

(c) Your net income is increased \$480.89, representing disallowance of deduction for medical expenses. Computation of adjustment is shown below:

Total medical expenses.....	\$ 1,003.14
Adjusted gross income as shown by the return	\$10,445.43

Add:

Net increase in income due to considering gain on sales of Exact-O-Matic franchise as ordinary income in lieu of long-term capital gain.....\$ 7,912.00

Increase in interest income.....	1.41	
Disallowance of deduction for repairs to two houses.....	2,008.87	9,922.28
Adjusted gross income as revised.....		\$20,367.71
Total medical expenses.....		\$ 1,003.14
Less: 5% of adjusted gross income as revised of \$20,367.71.....		1,018.39
Allowable deduction for medical expenses		None
Deduction for medical expenses claimed in your return		480.89
Increase in net income.....	\$	480.89

(d) Your net income is increased \$12,800.00, representing adjustment of ordinary income from the contracts covering Exact-O-Matic franchises. Computation of adjustment is shown below:

Selling price of Exact-O-Matic franchises shown by your return.....	\$12,800.00
Ordinary income from sales of Exact-O- Matic franchises	\$12,800.00
Ordinary income from sales of Exact-O- Matic franchises as shown by the return	None
Increase in net income.....	\$12,800.00

(e) Your net income is decreased \$4,888.00, representing elimination of capital gain reported on your return from sales of Exact-O-Matic franchises.

Income from the contracts covering Exact-O-Matic franchises held to be ordinary income in lieu of capital gain as reported in your return.

Computation of Tax

Net income	\$17,445.20
Less: 6 exemptions at \$600.00 each.....	3,600.00
<hr/>	
Income subject to tax.....	\$13,845.20
One-half of income subject to tax.....	\$ 6,922.60
Normal tax and surtax on \$6,922.60.....	\$ 1,672.78
Total income tax—twice the above normal tax and surtax	\$ 3,345.56
Correct income tax liability.....	\$ 3,345.56
Income tax liability disclosed by the return, Account No. AF 9 105, Arizona District.....	702.16
<hr/>	
Deficiency in income tax.....	\$ 2,643.40

Received and filed November 25, 1955, T.C.U.S.

Served November 28, 1955.

[Title of Tax Court and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, for answer to the petition of the above-named taxpayers, admits, denies and alleges as follows:

I.

Admits the allegations contained in paragraph I of the petition.

II.

Admits the allegation contained in paragraph II of the petition.

III.

Admits the allegations contained in paragraph III of the petition.

IV.

Denies the allegations of error contained in paragraph IV of the petition and all subparagraphs thereof.

V. 1, 4, 5, 8, 9, 11, 12, 13, and 14.

Admits the allegations contained in subparagraphs 1, 4, 5, 8, 9, 11, 12, 13, and 14 of paragraph V of the petition.

V. 2, 3, 6, 7, and 10.

Denies the allegations contained in subparagraphs 2, 3, 6, 7, and 10 of paragraph V of the petition.

VI.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that petitioners' deficiencies in income tax and the additions to the tax for the taxable years 1949, 1950 and 1951 in the amounts set forth in the statutory notice of deficiency be, in all respects, approved.

/s/ JOHN POTTS BARNES,
Chief Counsel, Internal
Revenue Service.

Filed January 24, 1956, T.C.U.S.

[Title of Tax Court and Cause.]

AMENDMENT TO ANSWER

Comes now the Commissioner of Internal Revenue, by his attorney, Nelson P. Rose, Chief Counsel, Internal Revenue Service, and for amendment to the answer filed in this case, alleges as follows:

V.

1. Denies that the petitioner, Joe L. Schmitt, Jr., was the owner of any patent recognized or granted by the United States Patent Office during any of the taxable years 1949, 1950, and 1951, involved herein.

Wherefore, it is prayed that petitioners' deficiencies in income tax and the additions to the tax for the taxable years 1949, 1950 and 1951 in the amounts set forth in the statutory notice of deficiency be, in all respects, approved.

/s/ NELSON P. ROSE,
Chief Counsel, Internal
Revenue Service.

Filed March 25, 1957, T.C.U.S.

Entered April 2, 1957.

Served April 2, 1957.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It is hereby stipulated for the purpose of this proceeding that the following statements shall be

accepted as true without prejudice to the right of either party to introduce other evidence not inconsistent therewith:

1. Petitioners are husband and wife, whose residence is 8540 North Central Avenue, Phoenix, Arizona. The returns for the years here involved were filed with the Collector of Internal Revenue, Phoenix, Arizona.

2. The petitioner, Joe L. Schmitt, Jr., was the inventor and sole owner of certain applications for patents, copyrights and registrations referred to under the trade name "Exact-O-Matic System." The System is an accounting method, described as being an automatic mechanical process, utilizing tabulating cards to evaluate single entry information, which produces double entry bookkeeping and accounting statements.

3. During the years 1949, 1950 and 1951, petitioner, Joe L. Schmitt, Jr., entered into 11 agreements entitled "Territorial Assignment of Patent." Photostatic copy of an agreement dated July 17, 1950, is attached as a sample agreement and marked Exhibit 1-A.

4. Attached hereto and marked Exhibit 2-B is a photostatic copy of an agreement entitled "District Franchise," dated July 17, 1950, as a sample of said agreements.

5. Attached hereto and marked Exhibit 3-C is a schedule entitled "Receipts of money by Joe L.

Schmitt, Jr., under the agreements referred to in paragraphs 3 and 4 of stipulation of facts.”

6. Attached hereto and marked Exhibit 4-D is a photostatic copy of an agreement between Joe L. Schmitt, Jr., and Exact-O-Matic Systems, Inc., an Arizona Corporation, dated only 1950.

7. For the year 1951, the Notice of Deficiency disallowed \$2,008.87, which had been deducted for alleged repairs on two homes. There is no issue with respect to the payment of the sum of \$2,008.87 by petitioner. The issue for the Court to decide is whether such expenditures was for repairs or constituted capital improvements to property. The general nature of such items is shown in Exhibit 5-E, attached hereto.

8. In each of the years here involved, the petitioner incurred total medical expenses as follows:

1949\$	523.47
1950	1,063.24
1951	1,003.14

It is agreed that the amount allowable may be determined under Rule 50 computation.

/s/ ROBERT ASH,

Attorney for Petitioner.

/s/ NELSON P. ROSE,

Chief Counsel, Internal Revenue Service, Counsel
for Respondent.

EXHIBIT 1-A

Territorial Assignment of Patent

This Agreement made and entered into this 17th day of July, 1950, by and between Joe L. Schmitt, Jr., of the City of Phoenix, County of Maricopa, State of Arizona, Party of the First Part, hereinafter designated "Assignor," and Howard N. Dietrich and J. W. Oswald, d/b/a Dietrich, Oswald & Co., Party of the Second Part, hereinafter designated "Assignee."

Witnesseth:

In consideration of the sum of Ten Dollars (\$10.00), and other good and valuable consideration, paid to Assignor by Assignee, the parties have agreed as follows:

(1) Assignor covenants that he is the owner of the entire right, title and interest in and to those certain United States Patents, Patents pending, Registrations and Copyrights hereinafter referred to as "Exact-O-Matic System," and that he has not mortgaged, pledged, hypothecated, or otherwise encumbered the same or any right, title, or interest therein in any manner whatsoever.

(2) Assignor hereby grants unto Assignee the exclusive right, privilege and franchise to use and sell the said Exact-O-Matic System (District, Unit A and Unit B), throughout the Territorial area described as follows:

All of the State of Oregon in addition to the counties of Cowlitz, Clark, Franklin, Walla Walla, Columbia, and Benton of the State of Washington, and to use, employ, and operate any and all methods, procedures, and processes covered by said Patents, Patents pending, Registration, and Copyrights, within and throughout the Territorial Area, and also any reissues or extensions thereof during the entire term of said Patents, Registrations, and Copyrights, subject, however, to the conditions and covenants hereinafter set forth. For the purposes of this agreement, the designation "Patent" is hereby defined to mean Patents, Patents pending, Registrations, Copyrights, and any oral or written agreement between the said "Assignor" and Remington-Rand, Inc., a Delaware Corporation, heretofore or hereinafter issued to Assignor, relating to double entry machine bookkeeping methods, procedures, and processes.

(3) Assignee agrees to use their best efforts to establish and/or sell District, Unit A and Unit B franchises, throughout the Territorial area, and to that end agrees to divide the Territorial area into Districts, and to grant licenses to operate said Exact-O-Matic System in said District, upon the conditions hereinafter set forth.

Assignee agrees to create and establish District No. 1 Franchise, either in their own name or by the assignment of the District to a corporation controlled by them within thirty (30) days from the date of this agreement, such District to embrace

the State of Oregon, Counties of Multnomah, Washington, Clackamas, Clatsop, Marion, Polk, Columbia, Yamhill, Tillamook and Lincoln, and the State of Washington, Counties of Clark and Cowlitz.

It is further understood and agreed that Assignee shall produce a minimum of sales of District Licenses, according to the following schedule:

On or before one year from the date of this Territorial Assignment, Assignee shall establish or sell a second District License, and every six months thereafter one additional District License, until a total of three District Licenses have been sold. The attached form of District License marked "Schedule A" shall be used in establishing said District Franchises.

Any sale of a District License, Unit "A" or Unit "B" License, to use said System shall be subject to approval of the Assignor, insofar as the competency and financial ability and integrity of the franchise applicant is concerned. All District License, Unit "A" and Unit "B" Licenses, shall be granted by the Assignee, subject to the conditions of that form of license marked "Schedule A, B or C."

(4) Assignee agrees that in granting Licenses for District, Unit "A" or Unit "B" Licenses, they will use the same form of contract hereto attached

(Schedules A, B, C) unless the parties hereto shall mutually agree upon a different form of contract.

The conditions of paragraph three (3) and four (4), as above stated, are for the protection of all other Territorial Assignees and to further insure an adequate sale price to the Assignor.

(5) Assignee shall have the right to fix prices for the sale of all Licenses within their territory, but agrees not to sell any District License for less than three thousand dollars (\$3,000.00), excepting, however, the assignment of District No. 1 to a controlled corporation; or sell any Unit "A" or Unit "B" Licenses for less than one thousand dollars (\$1,000.00) without approval of Assignor. Assignee shall also have the right to fix the price of Exact-O-Matic service to be made by District licensees, Unit "A" and Unit "B" licensees, to licensees customers for such services rendered.

(6) Assignee shall collect the sale price of each franchise granted within the territory and shall collect all royalties for the use of said Exact-O-Matic System, issued and granted by it pursuant to this agreement, and that when received it will pay to Assignor and/or his executors, administrators, and assigns, as his share of the business transacted within the territory herein described, the following:

(a) Sixty per cent (60%) of the sales price of each District License, Unit "A" or Unit "B" Li-

censes for said System and service, within the territory described herein; and in addition thereto;

(b) Fifty per cent (50%) of the gross royalties collected from such territory by Assignee, which royalties shall not be less than ten per cent (10%) of the gross fees charged by licensees for service under said license. Assignee to retain fifty per cent (50%) thereof as its share.

Assignee agrees to pay to Assignor his share of sales of District, Unit "A" and Unit "B" Licenses, and royalties by the fifteenth of each month for the preceding month's sales and royalties, and to accompany such payment with a detailed report of such receipts, including a duplicate of orders written for new business by the licensees within the said territory, and agrees that Assignor shall have access to the books and records of Assignee at all reasonable times for audit and examination.

(7) Assignee agrees to supervise all District, Unit "A" and Unit "B" Franchises and licenses in their territory and to use their best efforts and ability to promote and preserve the said business of each District, Unit "A" and Unit "B" licenses. Assignee further agrees to maintain a uniform type of service in conformity with the standard practice and in the manner prescribed by the methods, procedures, and process of Exact-O-Matic System, in all licensed operations within the territorial area.

(8) Upon the failure of the Assignee to make payment of Assignor's share of the aforesaid sales

of licenses and royalties for a thirty-day period after the time for which they are due, as herein provided, Assignor shall have the right to terminate this Territorial Assignment by serving a written notice upon Assignee, and Assignee shall have thirty days from date of such notice within which to cure any default hereunder and should such default not be cured within said thirty-day period, this agreement shall become null and void, and all monies heretofore paid by Assignee shall be retained as liquidated damages for breach of this agreement; provided, however, that Assignee shall not be discharged from any liability to Assignor for any license fees or royalties due at the time of the termination of this agreement; and provided, further, that a termination of this agreement for any reason shall not terminate any licenses theretofore granted by Assignee but shall operate as an assignment to Assignor, of all of Assignee's interest in such license, but no licensee shall be charged with notice of such assignment until receipt of written notice thereof by Assignor.

(9) Assignor agrees to arrange, without any further charge, a course of instruction and to fully train and instruct at his office in Phoenix, Arizona, all personnel of Assignee required to operate the equipment, methods, and procedures as employed and used by and under Exact-O-Matic System, in said District Number One License, provided, however, that all expenses of such personnel, including transportation to and from Phoenix, Arizona, and

their living expenses during the course of training, shall be without cost to Assignor.

Assignee agrees to arrange and give a course of training and instructions to the accountant and tabulating operator in Exact-O-Matic System as outlined. Said course shall be given to the personnel of each District Franchise for a period of not less than thirty days, beginning with the personnel of the Second District Franchise.

Assignee further agrees to arrange and give a course of training and instructions to the accountant and tabulating operator in Exact-O-Matic System as outlined for the personnel of Unit "A" and Unit "B" Franchises, and shall arrange with said Franchise Holders compensation for such service rendered in training said personnel and for such other service as may be necessary in the installation of said Unit "A" and Unit "B" Franchises.

(10) Assignor agrees to use his best efforts with manufacturers of necessary equipment to procure same for use by Assignee and its licensees, and agrees to procure such equipment designed and equipped with all devices necessary to process the work required under Exact-O-Matic procedure within three months of date order is accepted by Remington-Rand therefor, by such Assignee or its licensees.

(11) Assignor agrees to furnish all sample forms now or hereafter in use under Exact-O-Matic

procedure together with a complete Manual of Instructions for use by Assignees and its licensees.

(12) Assignor agrees to defend at his own expense any litigation arising within or without the territorial area challenging his right to use any of the aforesaid patents to the end that all rights secured to Assignee herein may be preserved.

(13) Assignee shall select its own personnel and employees and have complete dominion and control over them, and Assignor shall have no dominion or control over any of said employees except such as may be necessary in the course of training provided for in paragraph numbered "9" of this agreement, it being the intent and purpose of this paragraph to evidence the fact that Assignee is the territorial owner of the patent, operating completely independent of Assignor. Assignee agrees to pay all taxes levied or assessed against them, including industrial or security taxes for their employees, and to file all necessary reports and returns therefor.

Whenever any license shall be granted under this Assignment, the licensee thereunder shall be the territorial owner of the patent, having complete dominion and control over his or its employees and shall accept full responsibility for all taxes levied or assessed by reason of the operation of such license and shall file all necessary returns required therefor.

(14) Assignee shall have the right to grant

licenses for the full term of any of said patents and agreements, or for a shorter period, and if at any time or from time to time, any license or licenses so granted shall become terminated for any reason, Assignee shall have the right to grant such other licenses with respect to such district or districts and to increase or decrease the area thereof, as it may deem advisable, subject to the provision of paragraph three (3) of this Agreement.

(15) Assignee agrees not to assign or dispose of this Territorial Assignment in whole or in part without the written consent of Assignor.

(16) Time is the essence of this agreement.

(17) This agreement shall extend to and bind the parties hereto, their respective heirs, personal representatives, successors, and assigns.

In Witness Whereof the parties hereto have caused this Agreement to be executed the day and year first above written.

/s/ JOE L. SCHMITT, JR.,
Party of the First Part,
Assignor.

/s/ HOWARD N. DIETRICH,

/s/ J. W. OSWALD,
Party of the Second Part,
Assignee.

County of Multnomah,
State of Oregon.

Before me, Donna R. Reames, a Notary Public in and for the County and State aforesaid, personally appeared Howard N. Dietrich and J. W. Oswald, known to me or satisfactorily proven to be the persons whose names are subscribed to the within instrument, and acknowledged that they executed the same for the purpose therein contained.

In Witness Whereof, I hereunto set my hand and official seal.

[Seal] /s/ DONNA R. REAMES,
Notary Public.

My Commission Expires Feb. 7, 1954.

County of Maricopa,
State of Arizona.

Before me, Tony Duran, a Notary Public in and for the County and State aforesaid, personally appeared Joe L. Schmitt, Jr. (known to me or satisfactorily proven), to be the person whose name is subscribed to be the within instrument, and acknowledged that he executed the same for the purpose therein contained.

In Witness Whereof, I hereunto set my hand and official seal.

[Seal] /s/ TONY DURAN,
Notary Public.

District Franchise

This Agreement made and entered into this 17th day of July, 1950, by and between Howard N. Dietrich and J. W. Oswald, d/b/a Dietrich, Oswald & Co., Party of the First Part, hereinafter designated "Franchise Holder," and Exact-O-Matic, Inc., Party of the Second Part, hereinafter designated "Licensee."

Witnesseth:

That in consideration of the sum of Ten Dollars (\$10.00), and other good and valuable consideration paid to Franchise Holder by Licensee, and the royalties, covenants, and conditions hereinafter contained on the part of the Licensee to be paid, kept, and performed, the Franchise Holder does hereby grant unto the Licensee the exclusive right and License to use within the following-described area: Counties of Multnomah, Washington, Clackamas, Clatsop, Marion, Polk, Columbia, Yamhill, Tillamook and Lincoln, in the State of Oregon, and Counties of Clark and Cowlitz in the State of Washington, hereinafter called District Number One (# 1), (and in no other place or places), those certain double entry machine bookkeeping methods, procedures, and processes known as "Exact-O-Matic System," covered by the Patents, Patents Pending, Copyrights, and Registrations; and to use, employ and operate any and all methods, procedures and processes covered by said Patents, Patents Pending, Copyrights, and Registra-

tions within and throughout the said-described district, and also any reissue or extensions thereof during the entire term of said Patents, Copyrights and Registrations, unless this License should be sooner terminated as hereinafter set forth. The word "Patent" as used herein shall mean Patents, Patents Pending, Copyrights, Registrations, and any agreements, oral or otherwise, between the said Patent Owner and Remington-Rand, Inc., a Delaware Corporation, heretofore or hereafter issued to Joe L. Schmitt, Jr., of Phoenix, Arizona, from whom the Franchise Holder holds an exclusive franchise covering the Territorial area of the State of Oregon, and the Counties of Cowlitz, Clark, Franklin, Walla Walla, Columbia, and Benton, in the State of Washington, pursuant to that certain agreement, dated July 17, 1950, between the said Joe L. Schmitt, Jr., and the Franchise Holder.

This Franchise is made upon the foregoing and the following terms, covenants, and conditions, all and each of which the Licensee, on behalf of their successors and assigns, covenants and agrees with the Franchise Holder and their successors and assigns, to keep and perform.

The Licensee covenants and agrees:

(1) To pay to the Franchise Holder monthly, for the use of said procedures, processes, copyrights, and registrations in said District, a License fee equal to ten per cent (10%) of the gross fees charged by Licensee for services rendered by it

under said Exact-O-Matic System for each preceding calendar month, said sum of ten per cent (10%) to be paid not later than ten days after the close of each calendar month, it being understood and agreed that said monthly payments shall not be less than the minimum royalties provided to be paid under the succeeding paragraph four (4) hereof. Licensee further agrees to keep exact and correct records of the fees charged by it for said service and to render Franchise Holder a monthly account thereof, together with payment of said ten per cent (10%) due as herein provided at the office of Franchise Holder in Portland, Oregon.

(2) To make available to Franchise Holder and said Joe L. Schmitt, Jr., their agents, or employees, at all reasonable hours, its books of account and records, for the purpose of examining and auditing the same.

(3) To render said service in conformity with the standard practice and in the manner prescribed by the methods, procedures, and process of Exact-O-Matic System, and to allow Franchise Holder the right to inspect and supervise the Licensees' operation of Exact-O-Matic System to determine that said service is being rendered in accordance with the standard practice and method prescribed by Exact-O-Matic System.

Not to render or contract to render any service under said Exact-O-Matic System which would, in

any manner, violate any law or ordinance in force within said district.

(4) Should ten per cent (10%) of the gross fees charged by the Licensee as provided in the preceding paragraph one (1) hereof, fail to equal the amounts set forth in the following schedule of minimum royalties, the Licensee shall pay to Franchise Holder in addition monthly, as aforesaid, the amount by which said ten per cent (10%) of said gross fees falls short of the said minimum royalties. Following is the schedule of minimum royalties:

For the first 3 months, after the equipment described in paragraph 5 hereof has been installed in Licensee's place of business, not less than \$25.00 per month.

For the next 3 months, not less than \$50.00 per month.

For the next 3 months, not less than \$75.00 per month.

For the next 3 months, not less than \$100.00 per month.

For the next 3 months, not less than \$150.00 per month.

For the next 3 months, not less than \$200.00 per month.

Thereafter, through the term of this License, not less than \$250.00 per month.

(5) To forthwith place an order with Remington-Rand, Inc., for either group A or B equipment, adapted for Exact-O-Matic System.

Group A

One Model 3080—Tabulator.

One Model 306-1—Key Punch.

One Model 310—Multi-Control Reproducing
Punch.

One Model 220—Sorter.

Group B

One Model 265—Tabulator.

One Model 212—Key Punch.

One Model 310—Multi-Control Reproducing
Punch.

One Model 220—Sorter.

(6) Not to assign or transfer said License or any interest therein without the written consent of Franchise Holder, and approval of Patent owner. In the event said Licensee shall demise during the life of this agreement, all of said licensee's interest in said franchise shall inure to his estate and upon proper showing to the Franchise Holder and Patent Owner by said licensee's estate the same may be disposed of to competent parties who are qualified to conduct the business of said district licensee subject to approval by Franchise Holder and Patent Owner.

(7) To furnish to Franchise Holder upon its request, trade analyses of general business conditions as reflected from the operation and use of Exact-O-Matic System within the district served, upon forms provided by the Franchise Holder for the purpose of compiling trade information, said

trade information to be distributed to the users of Exact-O-Matic System within and without the district served by the Licensee. Franchise Holder agrees that if said trade analyses are published, said Licensee may purchase at cost such publications for general distribution within the district covered by this License.

(8) To furnish a surety bond in a company selected by Franchise Holder in the sum of One Thousand Dollars (\$1,000.00), to guarantee payment of the royalties and fees as herein provided.

(9) To enter all orders for Exact-O-Matic service taken by Licensee in quadruplicate, two copies to be mailed forthwith by Licensee to Franchise Holder, one to be given to Customer, and the original to be retained by Licensee, which said orders shall be numbered and all numbers accounted for.

(10) In the event Licensee shall perform and render service for a client within his district area which was secured directly through the efforts of another district licensee, then said licensee rendering the service shall make some satisfactory arrangement with the licensee securing the client in the manner of compensation. In the event said licensees shall fail to make satisfactory arrangements as between themselves, then Franchise Holder shall determine the compensation said licensee securing the client shall receive.

(11) It is mutually understood and agreed that all payments required to be made by the Licensee

to the Franchise Holder shall become due and payable on the 10th day of each calendar month; and if said payment or payments are not made within twenty (20) days after said due date, and if the Licensee fails to make satisfactory arrangements with the Franchise Holder for an extension of time in which to make said payment or payments, or upon the failure of Licensee to keep and perform any of the other terms and conditions required by the said Franchise Holder to be kept and performed, the said Franchise Holder may terminate this franchise and license by written notice to Licensee setting forth the terms and conditions which the said Licensee has failed to comply with; provided, however, the Licensee shall have twenty (20) days from the date of receipt of such notice within which to correct any default then existing and to comply with the terms and conditions hereinabove set forth; and, should such default not be corrected, and should the terms and conditions as hereinabove set forth not be complied with within the said twenty-day period, then at the expiration thereof this franchise and license shall become null and void, in which event all monies theretofore paid by Licensee to Franchise Holder shall be retained by Franchise Holder as liquidated damages for breach of this agreement, but Licensee shall not thereby be discharged from any liability to pay Franchise Holder any monies due at the time of such termination.

(12) Time shall be the essence of this Agreement.

In Witness Whereof the parties hereto have caused this Agreement to be executed the day and year first above written.

/s/ HOWARD N. DIETRICH,

/s/ J. W. OSWALD,

First Party, Franchise
Holder.

EXACT-O-MATIC, INC.,

By /s/ J. W. OSWALD,

Pres., Licensee.

County of Multnomah,

State of Oregon.

Before me, Donna Reames, a Notary Public, in and for the County and State aforesaid, personally appeared Howard N. Dietrich, and J. W. Oswald, known to me (or satisfactorily proven) to be the persons whose names are subscribed to the within instrument, and acknowledged that they executed the same for the purpose therein contained.

In Witness Whereof I hereunto set my hand and official seal.

[Seal] /s/ DONNA R. REAMES,

Notary Public.

My Commission Expires Feb. 7, 1954.

County of Multnomah,
State of Oregon.

Before me Donna Reames, a Notary Public, in and for the County and State aforesaid, personally appeared J. W. Oswald, President of Exactomatic, Inc., of Oregon, known to me (or satisfactorily proven) to be the person whose name is subscribed to the within instrument, and acknowledged that they executed the same for the purpose therein contained.

In Witness Whereof I hereunto set my hand and official seal.

[Seal] /s/ DONNA R. REAMES,
Notary Public.

My Commission Expires Feb. 7, 1954.

Approval of Patent Owner

This District License is approved this 4th day of October, 1950, pursuant to Paragraph three (3) of that certain Territorial Franchise entered into on the 17th day of July, 1950, by and between Joe L. Schmitt, Jr., of the City of Phoenix, County of Maricopa, State of Arizona, designated "Owner," and Howard N. Dietrich and J. W. Oswald, designated "Franchise Holder."

/s/ JOE L. SCHMITT, JR.,
Owner.

EXHIBIT 3-C

Schedule of Receipts of Money
by Joe L. Schmitt, Jr., Under Agreements
Referred to in Paragraphs No. 3 & No. 4
of Stipulation of Facts

From Territorial Agreements—1949:

	Amount Received	Alleged Expenses	Cost	Net Amount
California	\$ 4,965.02		\$1.00	\$ 4,964.02
Colorado	1,500.00		1.00	1,499.00
Florida	1,500.00		1.00	1,499.00
<hr/>				
Total	\$ 7,965.02		\$3.00	\$ 7,962.02

From District Agreements by Territorial Holders—1949:

<hr/>				
From Territorial Agreements—1950:				
Northern California	\$ 1,000.00		\$1.00	\$ 999.00
Texas	5,000.00		1.00	4,999.00
Georgia	6,500.00	\$1,000.00	1.00	5,499.00
Oregon	5,000.00		1.00	4,999.00
Oklahoma	1,000.00		1.00	999.00
Southern California	13,500.00		1.00	13,499.00
New Mexico	1,000.00		1.00	999.00
Idaho	5,000.00		1.00	4,999.00
<hr/>				
Total	\$38,000.00	\$1,000.00	\$8.00	\$36,992.00

From District Agreements by Territorial Holders—1950:

Pittsburgh, Pa.	\$ 5,000.00		\$1.00	\$ 4,999.00
Tulsa, Oklahoma	2,500.00		1.00	2,499.00
<hr/>				
Total	\$ 7,500.00		\$2.00	\$ 7,498.00

From Territorial Agreements—1951:

Ohio	\$ 5,000.00		\$1.00	\$ 4,999.00
Georgia	2,000.00		1.00	1,999.00
New Mexico	4,000.00		1.00	3,999.00
<hr/>				
Total	\$11,000.00		\$3.00	\$10,997.00

From District Agreements by Territorial Holders—1951:

San Fernando, Calif.....	\$ 1,800.00		\$1.00	\$ 1,799.00
<hr/>				
Total	\$ 1,800.00		\$1.00	\$ 1,799.00

Agreement

This Agreement, made and entered this day of, 1950, by and between Joe L. Schmitt, Jr., of the City of Phoenix, County of Maricopa, State of Arizona, hereinafter called the Party of the First Part, and Exact-O-Matic System, Inc., a Corporation duly organized and existing by virtue of the laws of the State of Arizona, hereinafter called Party of the Second Part.

Witnesseth:

(1) Party of the First Part is the sole owner of the entire right, title and interest in and to those certain United States Patents, Patents pending, Registrations and Copyrights referred to under that certain trade name "Exact-O-Matic System," and that he has not mortgaged, pledged, hypothecated, or otherwise encumbered the same, or any right, title, or interest therein in any manner whatsoever.

(2) Party of the First Part hereby grants unto the Party of the Second Part, subject, however, to the conditions and covenants hereinafter set forth in this agreement, and subject further to the provisions and limitations contained in the Territorial District, Unit "A," Unit "B" and Unit "I" franchises issued or to be issued, the exclusive right, privilege and franchise to use the registered trade name Exact-O-Matic System as its corporate name, to promote the sale of Territorial franchises within and without the limits of the United States or its

possessions, and to supervise the operation of said Territorial franchises already established or to be established.

(3) Party of the Second Part agrees to use its best efforts to promote and sell Territorial franchises throughout the United States and its possessions, it being understood and agreed that Party of the Second Part shall produce a minimum of sales of Territorial franchises of not less than five in any one calendar year or until all 48 States of the United States of America are sold, providing, however, tabulating equipment is available. In the event said tabulating equipment is not available due to conditions beyond the control of the Party of the Second Part, then Party of the First Part shall waive this specific provision of this Agreement until such time as said equipment shall be available.

(4) Party of the Second Part agrees to use its best efforts in the supervision of those Territorial franchises already established and those territorial franchises to be established and further agrees to enforce and carry to completion the covenants and provisions contained in said Territorial franchises.

(5) Party of the Second Part agrees to arrange, without any charge, a course of instruction and to fully train and instruct the personnel of each Territorial franchise required to operate the tabulating equipment to be used in the Exact-O-Matic process

in accordance with the provisions of the Territorial franchise.

(6) Upon the failure of the Party of the Second Part to comply with the terms and provisions of this Agreement, Party of the First Part shall have the right to terminate this Agreement by serving a written notice upon the Party of the Second Part and Party of the Second Part shall have thirty days from date of such notice within which to cure any defect hereunder and should such defect not be cured within said thirty-day period, this agreement shall become null and void and all monies due at said time to Party of the Second Part from Party of the First Part shall be retained as liquidated damages for breach of this Agreement by Party of the First Part, provided, however, that Party of the Second Part shall not be discharged from any liability to Party of the First Part for any monies or advances made to Party of the Second Part by Party of the First Part.

(7) Party of the First Part agrees to pay to Party of the Second Part from the proceeds received from the sale of Territorial District, Unit "A," Unit "B," and Unit "I" franchises an amount equal to:

25% of the Net Sale Price for each Territorial Franchise.

15% of the Net Sale Price of each District Franchise.

15% of the Net Sale Price of each Unit “A” Franchise.

15% of the Net Sale Price of each Unit “B” Franchise.

15% of the Net Sale Price of each Unit “I” Franchise.

In addition to the amounts computed upon the basis of the above schedule, Party of the First Part agrees to pay to Party of the Second Part 25% of the royalties when received by Party of the First Part from the Territorial Franchise Holders, said royalty being ten per cent (10%) of the gross fees for all service rendered by the Exact-O-Matic System process in all of the classifications of franchises granted.

In accordance with the provisions of the Territorial Franchise granted by Party of the First Part (Section 6-b) gross royalties are divided as follows:

Party of the First Part.....	25%
Territorial Franchise Holder.....	50%
Party of the Second Part.....	25%

(8) Party of the Second Part agrees not to assign or dispose of, mortgage, pledge, hypothecate or otherwise encumber this agreement or future proceeds therefrom in whole or in part without the written consent of the Party of the First Part.

(9) Time is the essence of this Agreement.

(10) This Agreement shall extend to and bind

the parties hereto, their respective heirs, personal representatives, successors, and assigns.

In Witness Whereof the parties hereto have caused this Agreement to be executed the day and year first above written.

/s/ JOE L. SCHMITT, JR.,
Party of the First Part.

EXACT-O-MATIC SYSTEM,
INC.,

By /s/ ROBERT R. WEAVER,
Vice President;

By /s/ TONY DURAN,
Ass't Sec'y-Treas., Party of
the First Part.

Filed March 25, 1957, T.C.U.S.

In the Tax Court of the United States
Docket No. 60267

In the Matter of:

JOE L. SCHMITT, JR., Et Al.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PROCEEDINGS

Phoenix, Arizona, Monday, March 25, 1957

The above-entitled matter came on for hearing,
pursuant to calendar call, at 11:45 a.m.

Before: The Honorable Arnold Raum.

Appearances:

CARL F. BAUERSFELD,
Washington, D. C.,
Appearing on Behalf of the Petitioners.

E. C. CROUTER,
Bureau of Internal Revenue,
Appearing on Behalf of Respondent.

The Court: Are you ready to proceed?

The Clerk: Docket Number 60267, Joe L. Schmitt, Jr., et al.

Will you state your appearances?

Mr. Bauersfeld: Carl F. Bauersfeld for the Petitioner.

Mr. Crouter: E. C. Crouter for the Respondent.

Mr. Bauersfeld: This case involves a deficiency in income tax for the years 1949, 1950 and 1951, in the total amount of \$12,032.56 the detail of which is as follows:

1949	\$ 31.44
1950	9,357.42
1951	2,643.40
<hr/>	
Total	\$12,032.56

Question Presented

1. Petitioner Joe L. Schmitt, Jr., invented a mechanical process utilizing tabulating cards to evaluate single entry information, which produces

double entry bookkeeping and accounting statements. During the years involved he sold all of his rights in this system known as the Exact-O-Matic System in certain territories. Petitioners reported the proceeds from the sales as the sales of a capital asset. The Commissioner determined the proceeds from the sales to be ordinary income. The first question for decision is: (1) Were proceeds from the sales of the Exact-O-Matic System during the years involved taxable as capital gains or as ordinary income? [3*]

2. Under provisions of the sales agreements Petitioner was required to provide a course of instruction or training for the personnel of the purchasers of the Exact-O-Matic System. In 1950 and 1951 Petitioner contracted with a Corporation known as the Exact-O-Matic System, Inc., to furnish the instruction to the purchasers' machine operators. The Corporation furnished this service and was paid by Petitioner \$10,375.00 in 1950, and \$3,020.00 in 1951. The Commissioner has failed to allow Petitioner a deduction for this amount. The second question for decision is:

Were Petitioners entitled to a deduction of \$10,375.00 in 1950, and \$3,020.00 in 1951, for expenses in connection with the training program?

The third question is in the same category. In 1950 Petitioner paid \$2,268.20 as an additional amount on account of the training program. Were Petitioners entitled to a deduction for the \$2,268.20 as expense in connection with the training program?

*Page numbering appearing at top of page of original Reporter's Transcript of Record.

Petitioners purchased certain rental property in 1951 and made repairs thereon. The Commissioner has disallowed all the repairs in 1951 totaling \$2,008.87 on the ground that they were capital expenditures. The fourth question for decision is: Were they expenditures for repairs or did they constitute capital improvements?

We have stipulated Petitioner's medical [4] expenses for each year involved and that the amount of medical expenses allowable may be determined under the Rule 50 Computation.

Mr. Crouter: If the Court please, there is one little matter in the pleadings here. I furnished Counsel a copy and I don't believe there is a controversy about it. But the Government's answer in this case admitted among various other things Petitioner did own and have a patent that had been granted by the United States Patent Office. It has subsequently developed, according to my understanding, Petitioner didn't have the patent. I have prepared and filed with the Court Clerk a motion to allow the filing of the amendment to the answer and the amendment to the answer is merely a correction of that one little point.

Mr. Bauersfeld: I have no objection. I reserve the right to see whether or not I need to file a reply, if I have the time.

The Court: The motion will be granted.

Mr. Crouter: The issues have been stated by Counsel for Petitioner and I don't think need any reiteration. The basic issue, of course, is whether the amounts received constituted capital gain as re-

ported or whether it was ordinary income of this Petitioner who is and for many years has been an accountant, whether it was moneys received by the Petitioner under these documents which will be stipulated.

There are two basic documents, the first [5] running to territorial operators in other states and then the further agreement between territorial operators and district operators in the various states, mostly in the West, I believe.

The Petitioner's position is that the Petitioner by these agreements did not transfer real property rights completely irrevocable, etc., which would constitute capital assets or capital properties which the distributors in these various states, the territorial distributors particularly owned wholly and conclusively.

I believe the evidence will show the Petitioner continued to further this accounting bookkeeping process which he developed. He helped to train people in the various states and followed through and Respondent's position merely is this was ordinary income received by the Petitioner from his operations partly by circularizing and using and licensing out this method of bookkeeping and records with a double entry bookkeeping system on the Remington Rand bookkeeping machine. This is not a service where the Petitioner has invented a machine, merely use of an idea supervised and controlled and licensed out by the Petitioner who was and is an expert accountant.

The expense issue goes along with that in connection with the operations there, of course, the question is whether this Petitioner himself had additional ordinary and necessary expenses of this business. Now, it may be that the position of the Petitioner may be a little inconsistent and the expense [6] issue may turn to some extent upon the Court findings and disposition of exactly what the business of the Petitioner constituted.

The Court: Why were these expenses disallowed?

Mr. Crouter: In connection with the operations of the Corporation, the evidence will show and I am a little hazy because I am not certain of the Petitioner's position but he had a corporation which, as I understand, he and his family chiefly owned, the stock and various operations by that corporation were carried on.

The expenses have been disallowed as expenses of the Petitioner, but treated as expenses of the Corporation, I believe.

Mr. Bauersfeld: I believe that is correct.

Mr. Crouter: The other question of rentals, the question is whether these were capital additions and improvements rather than just ordinary repairs. The evidence will show they run to substantial matters, heavy plumbing, a lot of things that require lumber and were sizeable permanent additions, betterments of the real estate property.

The Court: That is the expense issue again. Is there capital outlay in relation to that?

Mr. Crouter: It is my understanding that related

to the operation of Petitioner's business. It goes to some extent on what was his business and what was the Corporation's [7] business. Where the line is drawn, I don't know. The evidence will show. The Petitioners have stipulated these two agreements particularly and also the net itemization of the items and the costs and amounts expended constituting the repairs or capital additions to the real estate property so the facts are pretty clear in that connection.

Mr. Bauersfeld: I might say Petitioner, too, would like to know the Government's theory on the disallowing of the expense issues. We claim we have not any clear cut definition of why these were disallowed.

Mr. Crouter: I believe Counsel refers to elimination for deduction for the tabulating machine.

Mr. Bauersfeld: The \$2,200 item, the \$10,000 and \$3,000.

Mr. Crouter: There it would run to the question of how much, if any, this Petitioner operated apart from his corporation. There is a very close knit unit in the handling of various business operations and I think that extends into what they call the licensing arrangement as well as the other part of the case.

The Court: Your position on that is, I take it, this Petitioner never made these expenses but they were made by his corporation.

Mr. Crouter: I believe that is correct or at least not expenses of this Petitioner in his business.

The Court: In one form or another the burden will be upon [8] the Petitioner to show he was en-

titled to the deduction and we will see whatever evidence is presented by him in that connection.

Mr. Bauersfeld: At this time, I would like to introduce stipulation of facts. We have the original of the exhibits through 5-E.

(Petitioner's Exhibits 1 through 5-E were marked for identification.)

The Court: The stipulation and accompanying exhibits will be received.

(Petitioner's Exhibits 1 through 5-E were received in evidence.)

Mr. Bauersfeld: May I call my first witness?

The Court: You may.

JOE L. SCHMITT, JR.

was called as a witness on behalf of the Petitioner and having been first duly sworn, was examined and testified as follows:

The Clerk: State your name for the record.

A. Joe L. Schmitt, Jr.

By Mr. Bauersfeld:

Q. What is your occupation?

A. Public Accountant.

Q. How long have you engaged in accounting work?

A. Since 1925.

Q. Where have you engaged in accounting work?

A. In the state of Arizona and more particularly in and [90] around the city of Phoenix, Arizona.

(Testimony of Joe L. Schmitt, Jr.)

Q. Were you ever employed by the state of Arizona? A. I was.

Q. In what connection?

A. Beginning in 1925 I was employed as cost accountant and I was made auditor of the State Highway Department and continued in that job until sometime the latter part of 1928.

Q. Were you ever employed by any municipality or county in the state?

A. I was employed by Maricopa County as auditor beginning 1929 and continuing through until June of 1934.

Q. What is the principal town of Maricopa County? A. Phoenix, Arizona.

Q. Are you the holder of any copyrights, trademarks or patent applications? A. I am.

Q. Will you briefly explain what copyrights, trade-marks and patent applications you own?

A. I have several copyrights pertaining to material in connection with the Exact-O-Matic mechanical process. I have two registered trademarks and trade names in connection with the Exact-O-Matic System. I have several publications in relation to the working of Exact-O-Matic System, more particularly a procedure manual covering the entire mechanical [10] process and, in addition to that, I have patent applications pending.

Q. I hand you a document and ask you to identify it.

A. That is a receipt from the Registrar of Copyrights No. 31946 of the United States of America

(Testimony of Joe L. Schmitt, Jr.)

covering a copyright on a title Automatic Machine Bookkeeping for Small Businesses, which is dated December 6, 1946.

(Petitioner's Exhibit No. 6 was marked for identification.)

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: I have no objection.

The Court: It may be admitted.

(Petitioner's Exhibit No. 6 was received in evidence.)

Mr. Bauersfeld: I have a number of photostatic copies and ask if I may offer the photostat.

The Court: You may offer the photostats themselves provided they are clearly legible. I would prefer copies more legible than the copy that accompanied the stipulation of facts. They are poor copies and hard on my eyes.

Q. (By Mr. Bauersfeld): I hand you another document and ask you to identify it?

A. That is a receipt issued by the Registrar of Copyrights, U. S. Government, covering material entitled "Selling Exact-O-Matic Systems" and dated December 27, 1948. [11]

(Petitioner's Exhibit No. 7 was marked for identification.)

Mr. Bauersfeld: I offer it in evidence.

Mr. Crouter: No objection.

(Testimony of Joe L. Schmitt, Jr.)

The Court: It may be admitted.

(Petitioner's Exhibit No. 7 was received in evidence.)

The Court: These are matters which might well have been the subject of stipulation.

Mr. Crouter: It is the first time I saw them, your Honor.

Mr. Bauersfeld: The first document you saw, Mr. Crouter, at the first conference.

Q. I hand you a pamphlet and ask you to identify it.

A. It is entitled "Selling Exact-O-Matic System" (Outline for Salesmen), copyrighted in 1948.

(Petitioner's Exhibit No. 8 was marked for identification.)

Mr. Bauersfeld: I offer this document in evidence.

Mr. Crouter: As far as I am concerned, this is the first time I have seen this document. I think it should have more foundation or give me a chance to examine it.

Mr. Bauersfeld: This is the document copy by one of the copyrights that has just been introduced. The purpose is to show he had this. One of the issues stated by Respondent was that he takes the position he didn't have the property right to sell. This is a part of the evidence to show this [12] man had a property right to sell.

Mr. Crouter: My basic objection, your Honor,

(Testimony of Joe L. Schmitt, Jr.)

is it is obviously hearsay, something produced here and may have been used unless and until it is shown it is tied in with the taxable year.

Mr. Bauersfeld: It is made by this man. He has a copyright on it.

Mr. Crouter: It is hearsay what he said on former occasions. It is not shown to be material unless and until it is connected up with something that happened during our taxable year. Here is a document copyrighted in 1948. It is entitled "Selling Exact-O-Matic System." Is this referred to in our basic agreement in evidence?

Mr. Bauersfeld: It is referred to in the basic agreement as to what the assignees received. It is not referred to by title.

Mr. Crouter: I object at this point. I think it is out of order, no foundation laid for a document of this sort.

The Court: I would certainly not receive this document in evidence for the purpose of receiving the statement of anything set forth in it because that would be hearsay. If the document is proper evidence, it is evidence only because it itself is an operating fact. In that connection, I think it would be appropriate for Petitioner Counsel to show far more precisely than he has at this point the [13] connection between this document and this case. The general statement that it is connected in a broad, general way is not sufficient.

Q. (By Mr. Bauersfeld): What was the pur-

(Testimony of Joe L. Schmitt, Jr.)

pose of your preparing this document identified as Exhibit No. 8, Mr. Schmitt?

A. The purpose for which this document was prepared was to give a brief outline to franchise holders of the Exact-O-Matic System.

Q. Was it a part of the training program?

A. It was a part of the training program.

Q. Under the contract which has been stipulated to territorial assignees, were you required to furnish training to their personnel? A. I was.

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: I don't want to seem facetious. Mr. Schmitt, was this document, Exhibit 8, actually used in connection with the contract that you had outstanding during our taxable years, '49 through '51?

A. Mr. Crouter, it was used in connection with the over-all training program that was carried on.

Q. (By Mr. Crouter): Training program of what places?

A. Of the personnel of the territorial franchise holders.

Q. Did you have any dealings with such personnel or was it through the territorial managers or holders?

A. No; in other words, the personnel of the territorial [14] franchise holders we sold the franchise to came to our office in Phoenix, Arizona, for a training period in the territorial assignment.

Q. They came from the state of Oregon or

(Testimony of Joe L. Schmitt, Jr.)

Washington? A. Correct.

Q. Were they furnished a copy of this Exhibit 8? A. Correct.

Mr. Crouter: I have no objection.

Mr. Bauersfeld: We offer the document in evidence.

The Court: It may be admitted.

(Petitioner's Exhibit No. 8 was received in evidence.)

Q. (By Mr. Bauersfeld): I hand you a document and ask you to identify it.

A. This is a manual of procedure for Exact-O-Matic System, a mechanical processing system, and it was written by me, Joe L. Schmitt, Jr., copyrighted in 1948.

Q. When was it completed?

A. It was completed prior to the time it was copyrighted in 1948.

Q. Is it dated?

A. It is dated December 20, 1948.

Q. What connection does this document have with respect to the contract between you and the territorial assignee?

A. This is a complete outline which is used to teach not only the accountant but the machine operator for using the [15] mechanical process known as the Exact-O-Matic System.

Q. This was furnished to them according to the contract? A. Correct.

(Testimony of Joe L. Schmitt, Jr.)

(Petitioner's Exhibit No. 9 was marked for identification.)

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: I believe you testified it was copyrighted in 1948.

Mr. Bauersfeld: He said 1949.

Mr. Crouter: I thought the record showed 1948. The document shows copyrighted in 1949.

Mr. Bauersfeld: I offer the exhibit in evidence.

The Court: Admitted.

(Petitioner's Exhibit No. 9 was received in evidence.)

Q. (By Mr. Bauersfeld): I show you a document and ask you to identify it.

A. That is a receipt issued by the U. S. Patent Office, Serial No. 595855, April 17, 1950, for the registration of a trade name and trade-mark, Exact-O-Matic System.

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 10 was received in evidence.)

Q. (By Mr. Bauersfeld): I hand you a document and ask you to identify it.

A. This is a final registration under Serial [16]

(Testimony of Joe L. Schmitt, Jr.)

No. 552074 issued by the Commissioner of Patents on the 11th day of December, 1951, covering a trade name Exact-O-Matic and trade-mark.

(Petitioner's Exhibit No. 11 was marked for identification.)

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 11 was received in evidence.)

Q. (By Mr. Bauersfeld): I hand you another document and ask you to identify it.

A. It is a receipt from the office of the Commissioner of Patents No. 595856, dated April 17, 1950, covering the registration of a trade-mark and trade name Exact-O-Matic System.

(Petitioner's Exhibit No. 12 was marked for identification.)

Mr. Bauersfeld: I offer it in evidence.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 12 was received in evidence.)

Q. (By Mr. Bauersfeld): I hand you another document and ask you to identify it.

A. This is a final registration issued by the Commissioner of Patents, No. 552075, issued on

(Testimony of Joe L. Schmitt, Jr.)

December 11, 1951, to Joe L. Schmitt, Jr., covering the registration of the trade name [17] Exact-O-Matic System and trade-mark.

(Petitioner's Exhibit No. 13 was marked for identification.)

Mr. Bauersfeld: I offer it in evidence.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 13 was received in evidence.)

The Court: Do these different documents, Mr. Schmitt, all refer to the same system? They appear to be identified in different ways. In one of them I noticed there was a single word, "Exactomatic," without any hyphen. In another one, for example, Exhibit 12, there are two words, "Exact" and "Matic." There is no "O" in it at all and in still others it is "Exact-O-Matic."

A. It is all referring to the same mechanical system, just variations.

Q. (By Mr. Bauersfeld): I hand you a photostatic copy of a document and ask you to identify it.

A. It is a receipt issued by the Commissioner of Patents, Serial 103050, dated July 7, 1949, to Joe L. Schmitt, Jr., covering a mechanical method for double entry bookkeeping.

Q. This is a patent application?

A. Patent application.

(Testimony of Joe L. Schmitt, Jr.)

(Petitioner's Exhibit No. 14 was marked for identification.)

Mr. Bauersfeld: I offer it in evidence.

Mr. Crouter: No objection. [18]

The Court: Admitted.

(Petitioner's Exhibit No. 14 was received in evidence.)

Q. (By Mr. Bauersfeld): Was this the first application, Exhibit 14, you filed?

A. No; it was not.

Q. When was your first application filed?

A. The first application for patent filed the early part of 1948.

Q. (By Mr. Bauersfeld): I hand you another document and ask you to identify it.

A. That is a receipt from the U. S. Patent Office, No. 285029, dated April 29, 1952, and covers a mechanical method of double entry bookkeeping. The application is Joe L. Schmitt, Jr.

(Petitioner's Exhibit No. 15 was marked for identification.)

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 15 was admitted in evidence.)

(Testimony of Joe L. Schmitt, Jr.)

Q. Have you designed any wiring unit in the use of Exact-O-Matic System?

A. I have.

Q. I ask you to look at Counsels' table and ask you to identify the exhibit I placed upon the table.

A. That is a general accounting wire used in the [19] printing tabulators for Exact-O-Matic System.

Q. For what type machine is that?

A. That is used in a Model 300 tabulator of Remington-Rand.

Mr. Crouter: Excuse me, what are you talking about, any particular document?

Mr. Bauersfeld: No.

The Court: I still don't understand what this piece of apparatus is.

Mr. Bauersfeld: This is part of the Remington-Rand machine.

A. That is the translation boxing that fits into a printing tabulation causes information to be printed.

The Court: I would like to know if it is part of the Remington-Rand machine or something you, yourself, devised, accommodated and used with part of the Remington-Rand machine.

A. I designed it and it is used to produce the printing results from the Exact-O-Matic System. That is my property, although it is manufactured by Remington-Rand.

The Court: You assigned your interest in that to Remington-Rand?

(Testimony of Joe L. Schmitt, Jr.)

A. No, sir; I still retain it.

The Court: Proceed.

Q. (By Mr. Bauersfeld): I hand you a letter and ask you to identify it. [20]

A. That is a letter on Remington-Rand stationery, dated May 3, 1951, addressed to me and signed by R. C. Cooper, assistant supervisor of sales management, Control Division. The purpose of the letter was to confirm our understanding that the wiring unit, No. NB414055, which is used specifically by Exact-O-Matic franchise holders is not to be used or built except for any one except a franchise holder of Exact-O-Matic System of Joe L. Schmitt, Jr.

Mr. Bauersfeld: I offer the document in evidence.

Mr. Crouter: No objection.

(Petitioner's Exhibit No. 16 was received in evidence.)

Q. (By Mr. Bauersfeld): Will you explain the background and development of the system?

A. Going back to 1926 when I began to work at the State Highway Department, I began to investigate the possibility of tabulations being used in more of a general accounting nature than statistical manner it was then being used for. Over a period of time while working as an accountant I came up with the idea and proceeded to try to put them to use.

(Testimony of Joe L. Schmitt, Jr.)

Q. When did your idea finally jell into the Exact-O-Matic System?

A. The latter part of 1947.

Q. Did you have any development cost in connection with this system?

A. I did not. [21]

Q. Did you take any deductions on your returns for development costs? A. I did not.

Q. Have you incurred any legal expense in connection with it? A. I have.

Q. Just approximately what was the legal expense through the years up to the end of the year 1951?

A. A little over \$3,000 had already been expended at that point.

Q. How did you handle this expense?

A. It was set up and carried on my books of record as a capital account.

Q. You didn't take the expense for any of it?

A. No, sir; I did not.

Q. When was the Exact-O-Matic System as it is now known completed?

A. The latter part of 1947.

Q. When did you first file your patent application? A. The first part of 1948.

Q. Since 1947, have you changed the Exact-O-Matic System in any way? A. I have not.

Q. Will you explain what the Exact-O-Matic System is?

A. An automatic mechanical process that evaluates under [22] single entry transactions in tabulat-

(Testimony of Joe L. Schmitt, Jr.)

ing cards in accordance with the double entry bookkeeping equation.

Q. Will you briefly explain how it operates?

A. That is rather of a technical nature so I have prepared in brief and concise language the answer to that question. Exact-O-Matic System is a mechanical process using tabulating cards and equipment of special design where unit single entry information, representing a single unit business transaction is introduced into the process which results in each unit single entry being evaluated in accordance with the double entry bookkeeping equation—assets equal liabilities plus capital and in strict accordance with the rules emanating from the double entry bookkeeping equation, so when the evaluated unit single entry tabulating cards are introduced into a printing tabulator equipped with the specially designed wiring unit it will produce a complete set of double entry bookkeeping records from the books of original entry through the general ledger and subsidiary ledgers and in addition from the same tabulating cards make a current month and year-to-date operating or profit and loss statement and an unanalyzed balance sheet.

Q. I hand you a deck of red tabulating cards and ask you to identify them.

A. That is a deck of the specially designed tabulating cards in which is perforated single entry unit transactions. [23]

Q. Where would you get those cards from in using the System?

(Testimony of Joe L. Schmitt, Jr.)

A. These cards were prepared by a key punch operator on an ordinary Remington-Rand key punch taking the information from the data the same as a bookkeeper would take if he were posting manually.

Q. What does that particular set of cards represent?

A. This particular set of cards represents the unit transactions in a cash receipts and paid out section in the books of original entry and are cards that have not yet been processed through the mechanical process known as Exact-O-Matic System.

Q. Those are the red deck? A. Yes.

(Petitioner's Exhibit No. 17 was marked for identification.)

Mr. Bauersfeld: I offer them in evidence.

Mr. Crouter: May I ask a few questions?

The Court: Yes.

Q. (By Mr. Crouter): Mr. Schmitt, referring to these red tabulation cards you just testified about, who owns these cards? A. I do.

Q. In connection with what business, bookkeeping or business affairs, were these cards prepared?

A. You mean just the other day preparatory to this trial, I don't understand the question? [24]

Q. Are these merely representing or in relation to some business conducted during the taxable years? A. No; it is an example to show.

Mr. Bauersfeld: May I make a statement for the record in relation to this? It may help Counsel.

(Testimony of Joe L. Schmitt, Jr.)

The Court: You may make a statement.

Mr. Bauersfeld: The next few documents are merely offered to show the nature of the process in general, do not represent any business entries made during the taxable years, just to show the process to have the record show what the System does.

Mr. Crouter: Were they made recently?

Mr. Bauersfeld: They were made for the purpose of this case.

Mr. Crouter: Made in Schmitt's office?

Mr. Bauersfeld: Made in Mr. Schmitt's office.

Mr. Crouter: I have no objection if Counsel feels it is necessary for the case.

The Court: Admitted.

(Petitioner's Exhibit No. 17 was received in evidence.)

Q. (By Mr. Bauersfeld): I hand you another document and ask you to identify it.

A. This is a printed page of tabulated information processed through the Remington-Rand tabulator on which has been printed the results of the tabulating cards referred to as the pink deck. [25]

The Court: In other words, is that paper you have before the result of putting Exhibit 17 through the machine?

A. That is correct.

Q. (By Mr. Bauersfeld): Does that evaluate the information on Exhibit 17 as to what is single entry or double?

A. Yes, sir.

(Testimony of Joe L. Schmitt, Jr.)

(Petitioner's Exhibit No. 18 was marked for identification.)

Mr. Bauersfeld: I offer it in evidence.

Mr. Crouter: I would like to see it, please. This also is illustrative for the purpose of this trial?

Mr. Bauersfeld: Yes, sir.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 18 was received in evidence.)

Q. (By Mr. Bauersfeld): I hand you 18 cream colored cards and ask you to identify them.

A. These are the 18 master evaluating cards used in the process of Exact-O-Matic System.

(Petitioner's Exhibit No. 19 was marked for identification.)

Mr. Bauersfeld: I offer them in evidence.

Mr. Crouter: Your Honor, I object unless it is shown this is illustrative of the same system used during our taxable years. We may be getting away from 1949. It seems to me they ought to be connected with the taxable years a little more.

Q. (By Mr. Bauersfeld): Mr. Schmitt, the process of these [26] cards beginning with the pink cards which were Petitioner's Exhibit No. 17, was the system that you are describing the same as you used during the years 1949, 1950, 1951?

A. It is identical.

(Testimony of Joe L. Schmitt, Jr.)

Mr. Crouter: I have no objection.

Mr. Bauersfeld: I offer in evidence Petitioner's Exhibit No. 19.

The Court: Admitted.

(Petitioner's Exhibit No. 19 was received in evidence.)

Mr. Bauersfeld: If the Court please, I will have to offer several other documents to explain it and I think it will be clear at that time.

Q. I hand you a deck of cream colored cards and ask you to identify those.

A. These are single entry unit transaction cards, the identical information being perforated into them as contained in Exhibit 17 called the pink deck which have been evaluated through the Exact-O-Matic process.

Q. Am I correct in my understanding you take the pink deck by single entry information——

The Court: I suggest you refer to these exhibits by number, not by color.

Mr. Bauersfeld: May I suggest this be marked Petitioner's Exhibit No. 20?

(Petitioner's Exhibit No. 20 was marked for identification.) [27]

Q. (By Mr. Bauersfeld): Will you explain, beginning with Petitioner's Exhibit No. 17, which is the pink deck, what produces that set of cards which is Petitioner's Exhibit No. 20 for identification?

(Testimony of Joe L. Schmitt, Jr.)

A. I will have to elaborate just a little. Petitioner's Exhibit No. 17 is a deck of cards perforated in single entry information that has not been put through the Exact-O-Matic process but was placed in the printing tabulator with the wiring unit that I designed and in Petitioner's Exhibit 18 the printed results are shown from these cards but have not been evaluated in the process. Petitioner's Exhibit No. 19 referred to as a master evaluating card is a factor in the processing of the mechanical process. It is used along with other tabulating equipment. Now Exhibit 20 is a tabulation deck of cards with the identical information in it that has been perforated by a punch operator as was contained in Exhibit 17 but after that was finished, these cards were then put through the mechanical Exact-O-Matic process in which the 18 master cards in Petitioner's Exhibit No. 19 were used in function which produced the ultimate result as shown by the printed results from these cards.

The Court: In other words, Exhibit 20 is the product of putting Exhibits 17 and 19 together?

A. That is right, in the mechanical process.

Mr. Bauersfeld: I ask that this be marked [28] for identification as Exhibit No. 21.

(Petitioner's Exhibit No. 21 was marked for identification.)

Q. I hand you Petitioner's Exhibit No. 21 for identification and ask you to identify it.

(Testimony of Joe L. Schmitt, Jr.)

A. That is the printed results of Exhibit No. 20 in which the unit detailed cards have been evaluated in accordance with the double entry bookkeeping equation with the results Exact-O-Matic equation shown and have been posted in standard fashion into a double entry set of books, this particular section being receipts and paid out section of the books of original entry.

Mr. Bauersfeld: I offer Exhibits 20 and 21 in evidence.

Mr. Crouter: As I understand, these are illustrative of the process and recently prepared for this case?

Mr. Bauersfeld: Yes, sir.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibits 20 and 21 were received in evidence.)

Q. (By Mr. Bauersfeld): What language does the System use?

A. The System will use any language that employs the Roman alphabet.

Q. Will it use German? A. It will.

Mr. Bauersfeld: Will you mark this for identification? [29]

(Petitioner's Exhibit 22 was marked for identification.)

Q. (By Mr. Bauersfeld): I hand you Peti-

(Testimony of Joe L. Schmitt, Jr.)

tioner's Exhibit 22 for identification and ask you to identify it.

A. This is the printed results after the cards have been put through the Exact-O-Matic System translation process.

Q. What language is it in?

A. In the German language and is the same section of the box of original entry receipts and paid out as Petitioner's Exhibit 21.

Mr. Bauersfeld: I offer Exhibit 22.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit 22 was received in evidence.)

Q. (By Mr. Bauersfeld): Have you sold any of of your rights under the copyright, trade-mark or patent applications?

Mr. Crouter: I object. It seems to me that we are using words of art that are controversial and misleading, subject furthermore to written documents if he did make any transactions involving any of these. The word "sold" in this case is one that is conclusive of the issue the Court is to be called upon to determine.

The Court: It would be more desirable if the question can be framed in terms that are not conclusive of the issue in this case.

Mr. Bauersfeld: I think, your Honor, the witness [30] can testify as to his intention whether he thinks he sold and I think the Court has the right to have the benefit of that. I realize because

(Testimony of Joe L. Schmitt, Jr.)

we use the term it is not going to follow we call a cow a pig. The Court is going to find out what.

The Court: Your question is intended to elicit from him testimony of the very transactions before the Court for review.

Mr. Bauersfeld: My question is to find out if this man has disposed of any of his interests in the Exact-O-Matic System.

The Court: You may ask as to what disposition he made and the Court will determine whether they are sales or not.

Q. (By Mr. Bauersfeld): Have you disposed of any of your rights by way of copyright, trademark or patent application which you called the Exact-O-Matic System?

A. I have disposed of certain territorial areas of my rights in the Exact-O-Matic System process which I have referred to as territorial assignments.

Q. What did you understand you were doing at that time?

A. I understood I was giving whatever I had to the other person who was taking it.

Q. What territories or areas have you disposed of?

A. The territories of Washington, Oregon, Idaho, Utah, Nevada, California, New Mexico, Colorado, Oklahoma, [31] Pennsylvania, Ohio, Florida and Georgia.

Q. How many dispositions or assignments did you make?

(Testimony of Joe L. Schmitt, Jr.)

A. One for each of the states, I think. I don't quite understand your question.

Q. How many transactions did you have in disposing of the territories?

A. Well, I had one transaction for each state.

Q. In some states more than one area?

A. Well, yes, in California it was divided into two, northern and southern.

The Court: Of course, the word "disposing" may precipitate the very question before the Court for review. This witness may conceive he has disposed of something. The Government may conceive he merely entered into a contractual arrangement with somebody. I take it whether or not there is a disposition on the one hand or simple contractual arrangement on the other hand depends on viewing the arrangement in its entirety.

In view of the hour, this might be a good point at which to suspend. We will recess now until 2:00 o'clock.

(Whereupon, recess was had from 1:00 o'clock p.m. to 2:00 o'clock p.m.)

(The witness resumed the stand.)

Q. (By Mr. Bauersfeld): I show you Exhibit 1 and ask you is this the type of agreement under which you disposed of your territorial rights? [32]

A. It is.

Q. How many of those agreements did you enter into? A. A total of eleven.

Q. Are the territorial assignment patent agree-

(Testimony of Joe L. Schmitt, Jr.)

ments all in this form? A. They are.

Q. Do you still have any patent applications pending? A. I do.

Q. That is a patent application in regard to what?

A. In regard to the Exact-O-Matic mechanical process.

Q. Where is that pending?

A. The U. S. Patent Office.

Q. What is a district franchise or license referred to in the territorial assignment of patent?

A. That is an assignment of a portion, a well-defined portion of a territorial franchise.

Q. Who makes that assignment?

A. The territorial franchise holder.

Q. I show you Exhibit 2-B and ask you if that is the district franchise you are referring to?

A. It is.

The Court: I have read over Exhibits 1-A and 2-B and I am considerably in the dark as to just how these so-called assignments or arrangements worked. There are references to phrases that are not meaningful to me. For example, Page 1 [33] of Exhibit 1-A, there is referred to the term "District," Unit A and Unit B. I have no idea of what Unit A and Unit B are all about. These terms are not defined. I cannot tell from Exhibit 2 just what it is the so-called licensee does in relation to Exhibit 2, whether the licensee uses this, whether the licensee in turn operates the system in favor of some third or fourth party, just what is involved.

(Testimony of Joe L. Schmitt, Jr.)

I would like the witness to start from the beginning and tell me what this whole set-up is all about.

Mr. Bauersfeld: My next question deals with Unit A.

The Court: Can you start from the beginning without going into the details of the machinery involved and tell me who these various people are, what service they render for whom?

A. To start with, your Honor, I issued a territorial assignment of all the rights as far as the Exact-O-Matic System is concerned either public, quasi public or certified public accountant operating in a state.

The Court: That is a person you designate as a franchise holder?

A. Territorial franchise holder.

The Court: What does he do?

A. He has the same rights I have. I passed it to him. He had a right in his state covered by his territorial assignment to cut that state up into district franchises for [34] operations usually within a well-defined trading area such as a county or several counties where an accountant would operate the system. In turn, the territorial franchise holder of this state supervised the district franchise holder, in other words, assisted and helped him.

The Court: Just what was the territorial franchise holder? He didn't operate the system, did he?

A. He did.

The Court: What did the district man do? Shall

(Testimony of Joe L. Schmitt, Jr.)

we call him the licensee? Let's get a term for him. Your document, Exhibit 1-A, seems to refer to the first man as a franchise holder. He is the assignee under your Exhibit 1-A. The next man in the chain of events is a man that is referred to as a licensee in Exhibit 2-B. What does the licensee do?

A. The licensee takes a well-defined territory within the state that is assigned to the territorial franchise holder by my assignment and gets up a practice.

The Court: What is his operation?

A. Doing mechanical bookkeeping-mechanical double entry Exact-O-Matic System.

The Court: For whom?

A. Various clients he may have or subsequently secure. That is done under the supervision of the territorial franchise holder.

The Court: The ultimate consumer, so to speak, is the [35] business that is being serviced by the licensee?

A. That is correct, sir. However, the territorial franchise holder also has a district license in his own operation. In other words, it is a public accountant who when he is assigned the state takes a territorial assignment for the rights I have to use it and to sell it. He has a district license also and he sets up his own operation under the district license and operates it according to the terms of that license.

The Court: The ultimate source of revenue or business is business concerned within the area?

(Testimony of Joe L. Schmitt, Jr.)

A. That is correct.

The Court: Those business concerns pay fees either to the so-called licensee or to the so-called franchise holder if the franchise holder operates directly without the intervention of the licensee?

A. That is correct, based upon the fees paid by small businesses for these franchise holders and district franchise holders.

The Court: What services are rendered to these so-called small businesses or I may refer to them for want of a better term as ultimate consumers?

A. The monthly bookkeeping records are kept and maintained the same as on a manual basis; in other words, taking it from the original data. Profit and loss statements are furnished to them just like you would do manually, an [36] accountant servicing client. In other words, by this we were able to bring tabulating and tabulating methods down to little businesses who heretofore couldn't afford to handle that service. An accountant with Exact-O-Matic System can service a great many accounts with much less personnel than if he were doing it on a manual basis.

The Court: So that your franchise holders and your licensees were accountants; they, in turn, served what you describe as small businesses within their respective areas?

A. That is correct, sir.

The Court: Using the system you have testified you have devised?

A. That is correct, sir.

(Testimony of Joe L. Schmitt, Jr.)

Q. (By Mr. Bauersfeld): Mr. Schmitt, the territorial assignee under Exhibit 1-A was also the district franchise holder of District License No. 1 in the territory?

The Court: What does No. 1 mean? Does that have significance? Is there a District No. 1 in every territory?

A. Yes, your Honor, because the territorial man became also the district man. No. 1 is an operating franchise. The other was selling, supervising, etc.

The Court: How many districts were there?

A. In some cases the territorial man, the territorial assignee, had the right to sell other districts so he would create districts from two or three within that state. [37]

The Court: Were there some instances in which District No. 1 was the only district?

A. Yes; that is true.

The Court: What is meant by Unit A and Unit B?

A. Unit A franchises were provided in the event——

The Court: What were they?

A. They were the rights to use Exact-O-Matic System in one individual industry or one point. For instance, if XYZ Company wanted to use the System to do its bookkeeping and so forth, that was arranged for so it could be handled through the district and territorial man; in other words, not through a public accountant but XYZ Com-

(Testimony of Joe L. Schmitt, Jr.)

pany who wanted to use it for its bookkeeping methods.

The Court: I am afraid I don't understand. Tell the difference between Unit A and Unit B.

A. Unit B, unlike the district franchise referred to, the district franchise being through an accountant who had a number of clients. Unit A franchise was designated for one company.

The Court: Designated to the company or accountant?

A. To the accountant for use in this company. In other words, it could be only used in that one operation they had.

The Court: In other words, Unit A was for an accountant with one client. Unit B was for accountants with multiple clients? [38]

A. Unit B was for accountants who had two, three or four clients, just like the accountant who had Unit A franchise only he was allowed to use it in two or three places of his clients. We tried to make distinction between uses of the district where there was no limitation. The district holder could have 50 clients or 500 clients.

Q. (By Mr. Bauersfeld): Were any Unit A or Unit B licenses ever issued?

A. No; they were not.

Q. Did you, under the territorial assignment of patent agreement, set up a training program of employees of the purchasers of the territorial areas? A. I did.

Q. Why?

(Testimony of Joe L. Schmitt, Jr.)

A. It was necessary to teach some one else in order to, in other words, pass my knowledge on to them, so the System would be operative. If I ever hoped to realize anything from the use of the mechanical process, other people had to use it so I could get some compensation.

Q. In addition, you were required to do it under the contract?

A. In addition, the territorial provision provided for this.

Q. Why didn't you sell your Exact-O-Matic System in toto to one person? [39]

A. That would be impossible and impractical for this reason: That Exact-O-Matic System is strictly a tool of the accounting profession. Accounting is regulated by statutory provisions in all of the states. In other words, it is just impractical for one accountant in the state of Arizona to start doing bookkeeping with Exact-O-Matic System for clients in the state of Oregon.

The other thing is under some of the state laws he has to be a resident before he could be provided the license to practice. You have conflict that might make it impossible to perform that way.

Q. Why couldn't you sell it to a national firm of accountants like Ernst & Ernst?

A. There are national firms engaged in the accounting profession but the national firms don't do bookkeeping for small businesses; engaged in audit, consultation of big business, don't go to the level

(Testimony of Joe L. Schmitt, Jr.)

this was made for, to service small businesses in the bookkeeping field, double entry books.

Q. What effort did you make or use to solicit the sales of Exact-O-Matic System?

A. Personally, I made none. Upon acceptance of this System and putting it into operation with Remington-Rand equipment and the things that go along with that, they sent out the announcement throughout the United States, released publicity on it, things of that nature. All of a sudden I [40] became swamped with inquiries coming from all the states, foreign places and everything else.

Q. What does Remington-Rand have to do with the System?

A. Remington-Rand manufactures the basic tabulating equipment that is used and, in addition, manufactures that wiring unit.

Q. Known as what?

A. Known as the Exact-O-Matic System wiring unit.

Q. Have you ever applied for any other copyrights, trade-marks or patents?

A. I have not.

Q. Have you ever sold any other patent applications, trade-marks, copyrights?

A. I never have.

Q. Over the years, what has been your business?

A. Public accountant.

Q. Were you a party to the district franchise?

A. I was not.

(Testimony of Joe L. Schmitt, Jr.)

Q. What did you have, if anything, to do with the district franchise?

A. I only had the right of approval on a man's ability, if he was an accountant, his integrity, his honesty and financial ability to carry through.

Q. What did you actually do to check on the district franchise holder? [41]

A. In most cases, rely on the territorial man who had the territorial assignment, in some few cases check Dun & Bradstreet or retail credit report on the man's financial standing I wasn't sure about.

Q. Did you ever refuse to approve any district franchise application? A. No.

Q. What right of supervision did you have over the territory assignees? A. No rights.

Q. What right of supervision did you have over the district franchise holder? A. None.

Q. Under your territory assignment, did the assignee have the right to make anything?

A. If you mean by the word "make" to use the machine process that I had invented in which single entry information tabulation card was transferred to the double entry information according to the equation, yes, he had a right to make that but if you mean "make" like you manufacture an article or something else, I didn't have the rights to make it either. In the first place, I didn't make it so if I didn't make it, he couldn't make it, but he had a right to use what I had made because to me this mechanical process is very similar to a pharma-

(Testimony of Joe L. Schmitt, Jr.)

ceutical formula in which the elements are [42] involved. The inventor invents it only once. When others take it, they have a right to recompound it or use it but can't make it because you can only make a process once.

The Court: Would you explain more clearly than set forth in this exhibit just how you were paid?

A. On the territorial assignment where my rights were granted to a territorial franchise holder such as shown in Exhibit 1-A, a value for that area was established by the amount of volume of trading area contained within the territory described in Exhibit 1-A. As an illustration, I will use the sum of \$5,000.

The Court: Is anything of that sort set forth in Exhibit 1-A, any lump sum?

A. No; no lump sum. All of them carried the consideration the sum of ten dollars and other valuable consideration.

The Court: So that Exhibit 1-A had no lump sum?

A. That is right.

The Court: Were you paid in connection with Exhibit 1-A only through a fraction of royalties?

A. In addition to the payment of the lump sum for the acquisition of the territorial assignment of patent fee set up.

The Court: I didn't understand there was any lump sum involved.

Mr. Bauersfeld: May I explain there is another

(Testimony of Joe L. Schmitt, Jr.)

exhibit [43] in the record that shows the amounts received.

The Court: Those are general. I am asking about the particular assignment involved in 1-A. Was there any lump sum received in connection with 1-A?

A. In Exhibit 1-A there was a lump sum settlement, I mean a first settlement made for the territorial franchise, the territory of Oregon and a part of Washington which was in the trading area.

The Court: That lump sum is not shown?

A. No, sir.

The Court: Exhibit 3-C does show receipts of money but the heading is further limited by describing those receipts as being receipts under agreements referred to in Paragraphs 3 and 4, Stipulation of Facts 3 and 4 in turn refer to Exhibits 1-A and 2-B and so if I were to read Exhibit 3-C literally I wouldn't find included in Exhibit 3-C any of the so-called lump sum payments you are talking about. I wish you would clarify that. If it does, you have not set it forth with the precision you should. I am having great difficulty trying to find from your exhibits just what your case is all about.

Mr. Bauersfeld: Exhibit 3-C is intended to show the amounts received. We had this difficulty in wording it to have any stipulation because plain words fail "assignment" and other words. It is referred to in that way in order that we could stipulate. These amounts here say from territorial

(Testimony of Joe L. Schmitt, Jr.)

agreements [44] mean the original amounts and 3-C shows the district agreements, the amount received from the district.

The Court: These amounts received in your view include not only lump sum payments but also payments geared to royalties?

Mr. Bauersfeld: No; the payments geared to royalties were returned as ordinary income, the lump sum payments as capital gain.

The Court: Exhibit 3-C involves only the lump sum payments?

Mr. Bauersfeld: Yes.

The Court: Does the Government agree?

Mr. Crouter: I believe the amounts involved in 3-C are the ones before the court here. I don't concede all these amounts were made for entering into that agreement and there is question as to where the line is drawn on initial negotiations and thereafter. I think the so-called royalty referred to in the district agreement are separate and apart from this.

The Court: Mr. Schmitt, you testified you had a lump sum from the assignee, the franchise holder?

A. That is right.

The Court: What further compensation did you get?

A. In the case of where the territorial assignee sold a district franchise reading the first district franchise with the territorial for which he paid nothing; in other words, [45] the two moved out together. If he sold a second one, then he was, upon

(Testimony of Joe L. Schmitt, Jr.)

the sale of that, to return, according to the territorial assignment, a certain per cent of that lump sum sales price to me as additional consideration for the territorial assignment.

The Court: That is shown on Exhibit 1-A in Paragraph 6-A, that is 60% of the sales price of each district license Unit A or Unit B license in the territory described?

A. That is described, sir.

The Court: In addition to that percentage of that lump sum, what other compensation did you receive?

A. In addition to that, the district franchise paid a ten per cent royalty on his monthly service fee for his various clients to the territorial franchise holder. The territorial franchise holder, in turn, retained 50% of that and remitted the other 50% to me which I treated as a royalty and ordinary income and so reported.

The Court: Now is there involved in this case any items received under Paragraph 6-A of Exhibit 1-A?

Mr. Bauersfeld: The Court's question is whether there is any money other than 6-A involved?

The Court: My question is whether there was involved in this case amounts that were paid under Paragraph 6-A of Exhibit 1-A?

Mr. Bauersfeld: The answer is yes, three were involved. [46]

The Court: Then this case involves two kinds of lump sum payments, first a lump sum payment with the franchise holder paid to the Petitioner for the

(Testimony of Joe L. Schmitt, Jr.)

franchise, amounts that are not spelled out in Exhibit 1-A at all. Secondly, there is involved in this case 50% of lump sum payments which the district licensee paid to the franchise holder. So there are two kinds of lump sum payments involved here.

Mr. Bauersfeld: That is correct.

The Court: I think I understand it at this point but I had to get it by pulling teeth and am not pleased with the way the matter has been presented up to this point.

Mr. Bauersfeld: Exhibit 3-C shows the amounts from the territory and from the district that were received.

The Court: Proceed.

Q. (By Mr. Bauersfeld): In the territorial assignment of patent Paragraph 15 provides "Assignee agrees not to assign or dispose of this territorial assignment in whole or in part without the written consent of the assignor." Why was that put in the agreement?

A. The mechanical process known as Exact-O-Matic System is strictly a tool of the accounting profession and some method had to be used to safeguard it from falling into the hands of someone not qualified to use the System. That was not only a protection for me but to the other franchise holders, whether district or territory. [47]

Q. Could you as assignor revoke or terminate a territorial agreement?

A. I could not. The only exception as outlined

(Testimony of Joe L. Schmitt, Jr.)

in the territorial assignment was for the failure of payment for it.

Q. Did you ever withhold approval of a territorial assignee to assign the agreement?

A. I never did.

Q. Could you revoke or terminate any district franchise? A. I could not.

Q. Are all territorial assignees operating in accordance with the agreement?

A. They are not.

Q. What is the situation as to them?

A. Going out of business.

Q. Why haven't you terminated the agreements?

A. I have no rights where I can.

Q. Which of the territorial assignees have failed?

A. Washington, Oregon, territory of Utah, Nevada, Idaho, northern California, New Mexico, Pennsylvania, Florida, Georgia.

The Court: I don't understand why you couldn't do something about the situation in which the assignees have gone out of business. I am looking at Paragraph 3, Exhibit 1-A in which the Assignees agree "to use their best efforts and/or to sell Unit A, Unit B franchises" and since your ultimate compensation will depend in substantial part [48] to the extent of activity of the assignee, I raise the question, do not suggest the answer, as to whether you might not have some remedy by reason of the assignee's failure to comply with Paragraph 3.

A. May I answer that, your Honor?

(Testimony of Joe L. Schmitt, Jr.)

The Court: Yes.

A. At the outbreak of Korean hostilities, there was imposed upon the manufacturers of equipment such as Remington Rand what is known as priorities for strategic materials. At that time and prior to that time when this was being operated, we were computing a 90 day guarantee delivery including myself as grantor of assignment and Remington Rand as manufacturer of the equipment which they were to use. When the priorities became effective, due to the nature of our operation, we were not engaged in any war effort of any kind, merely the practice of public accounting, we couldn't obtain these priorities. As a consequence, no machines would be manufactured. That continued for a period of a little over two years before released. In that period the impetus of carrying through was lost. One had a fire, dissolution of partnership, things of that kind more or less brought it to a point where there was more or less of a standstill. Upon the advice of my counsel who had gone through this franchise, helped draw it up before it was issued, no reservations whatever were made as long as they didn't owe me any money which they didn't. When they ceased [49] operation, I could do nothing about it.

Q. (By Mr. Bauersfeld): Under the district franchise agreements, you would receive as royalty an amount equal to 50% of the amount of the territory assignee from the district franchise holder, how did you receive it? A. As ordinary.

(Testimony of Joe L. Schmitt, Jr.)

Q. What is Exact-O-Matic System of Arizona?

A. It is a corporation set up to render book-keeping service to the clients in Arizona, especially in Phoenix, using the Exact-O-Matic System.

Q. Did you undertake to set up a program to train employees? A. I did.

Q. Will you explain what you did to set up the training program?

A. The first thing I had to do was to train the personnel of Exact-O-Matic System Corporations of Arizona. At that time, I was the only one who knew anything about it. During the year 1949 I devised the procedure of manuals, reduced the notes to outline and set up a complete training program that carried on for a period of 30 days or one month for the personnel of each franchise holder, including accounts and machine operators.

Q. Who trained the personnel? In 1949?

A. I did myself. [50]

Q. In 1950 and 1951 who trained the personnel?

A. The personnel of Exact-O-Matic System, Inc., of Arizona.

Q. Did you have a contract with them?

A. I did.

The Court: With whom?

Mr. Bauersfeld: Exact-O-Matic System, Inc., of Arizona.

Q. I show you Exhibit 4-D and ask you if that is the contract you referred to?

A. That is the contract.

Q. It is dated 1950. When was it actually made?

(Testimony of Joe L. Schmitt, Jr.)

A. The latter part of December, 1949.

Q. For the year 1950 how much did you pay the corporation for training the personnel of territorial assignees? A. \$10,375.

Q. How much did you pay the corporation in 1951? A. \$3,020.

Q. How were these amounts determined?

A. These amounts were determined in accordance with the agreements marked here Exhibit 4-D.
Mr. Bauersfeld: May I have this marked?

(Petitioner's Exhibit No. 23 was marked for identification.)

Q. I hand you Petitioner's Exhibit No. 23 for identification and ask you to identify that.

A. This is a computation based upon the terms of the [51] agreement by which the Exact-O-Matic System of Arizona, Inc., was to be compensated for its service by me, and shows for the year 1950 that the sale of territorial franchises equaled and totaled \$38,000 which according to the terms of the contract Exact-O-Matic System of Arizona was to receive 25% or \$9,500.00. During the year 1950 the sales of district franchise totaled \$7,500.00. According to the terms of the contract they were to receive 15% of this amount or a total of \$1,125.00, making the total \$10,625.00.

However, during the year 1950 I paid \$1,000.00 as commission to the Florida territorial franchise holder for his help and assistance in negotiating the sale of the territorial franchise for Georgia. Since

(Testimony of Joe L. Schmitt, Jr.)

I had remitted 25% and 15%, respectively, of the gross sales of franchises, I was entitled to deduct 25% from what I had on them for this portion of expense for the \$1,000 paid to the Florida territorial franchise holder, which leaves \$10,375.00.

During 1951 the sales of territorial franchises amounted to \$11,000, 25% of which was \$2,750.00. The sale of district franchises amounted to \$1800 at 15%—\$270.00, net amount due to Exact-O-Matic System of Arizona \$3,020.00.

Mr. Bauersfeld: I offer Exhibit 23 in evidence.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 23 was received in evidence.) [52]

PETITIONER'S EXHIBIT No. 23

Year 1950

1950 for the sum of \$10,375.00 which was computed as follows:

Sale of Territorial Franchises—\$38,000.00 at 25%.....\$ 9,500.00

Sale of District Franchises—\$7,500.00 at 15%..... 1,125.00

Total\$10,625.00

Less 25% of the \$1,000.00 commission paid to the
Florida Territorial Franchise on the sale of
the Territorial Franchise for Georgia..... 250.00

Net amount due Exact-O-Matic Systems of Arizona.....\$10,375.00

Year 1951

During the year 1951 the following sales were made:

Sale of Territorial Franchises—\$11,000.00 at 25%.....\$ 2,750.00

Sale of District Franchise—\$1,800.00 at 15%..... 270.00

Net amount due Exact-O-Matic System of Arizona.....\$ 3,020.00

Admitted in evidence March 25, 1957.

Q. During the year 1950 did you have any other expenses for the training of personnel?

A. I did.

Q. What was that?

A. It was additional compensation for the use of machines and services of the employees of Exact-O-Matic System, Inc., of Arizona amounting to \$2,200 some dollars. I don't remember the exact amount.

Q. If you contracted with the corporation Exact-O-Matic System, Inc., of Arizona to train personnel, why would you incur an expense?

A. Under the terms of the agreement that I made Exact-O-Matic Systems, Inc., of Arizona was to train machine operators during the year 1950. There was the personnel of eight territorial franchises trained in the home office of Phoenix, Arizona, which meant it was impossible for me to train that many accountants in that period of time. Many times we had two franchises training at the same time or overlapping. So I used the services of the employees of Exact-O-Matic System, Inc., of Arizona.

(Testimony of Joe L. Schmitt, Jr.)

The Court: Were you one of those employees?

A. No, sir, I am an officer but not an employee of the company. The expenses incurred for our employees including two accountants which were Mr. Hammett, McCowsky, Mr. Shaddegg, machine shop operator; Mr. Austin, machine shop [53] operator, amounted to some \$12,000 alone. In addition, the machine rental that Exact-O-Matic System of Arizona had paid, a little over \$6,000 plus additional cost for paper and cards brought it well over \$20,000 and they had received some \$10,375. Putting it briefly, it boiled down to where the corporation felt they had to be paid more for the services they rendered beyond the scope of the agreement entered into.

It so happened at that particular time we settled on the proposition if I would pay four months machine work and some supplies to Remington Rand then due we would call the account square between us, which we did, so I issued my check direct.

The Court: Mr. Crouter, do I understand the chief issue between you and the Petitioner in connection with this item is whether or not the Petitioner, in fact, paid the item as distinguished from whether or not the Corporation paid it?

Mr. Crouter: Not only payment but a question of whether or not—a question of whose obligation it was, whether the people rendering the service were working for Mr. Schmitt individually or this corporation. I don't think this relationship is fully developed yet.

(Testimony of Joe L. Schmitt, Jr.)

The Court: That would be immaterial if the Corporation were rendering services for Mr. Schmitt and it used its employees for that purpose.

Mr. Crouter: It may be a question of whether he is [54] volunteering the payment, whether the corporation is exclusively doing the job or both. I am not certain under his method of operation or the testimony up to this point.

The Court: The fact of the payment is in issue.

Mr. Crouter: No, a question of who the employer was, for what purpose, etc., also the beneficiary of the payment under his agreement. For instance, I could pay some garage rental attendant's service but it is voluntary on my part.

The Court: As I understand the issue in this case, it is pursuant to Exhibit 1-A and similar agreements. The Petitioner was under obligation to furnish certain instructions to the franchise holders. He could have furnished that instruction directly or could have paid somebody else to furnish it for him. His position here apparently, unless I misapprehend it, is that he used a corporation which had certain employees as the means of complying with his obligation under Exhibit 1-A. It would seem immaterial to me whether he paid these employees or paid the corporation as long as he was paying a reasonable amount for the purpose of discharging that obligation under 1-A.

Mr. Crouter: As I understand, the corporation is a separate entity and separate taxpayer.

A. Yes, sir.

(Testimony of Joe L. Schmitt, Jr.)

Mr. Crouter: That poses the question but it is tied up with what the corporation will do and what the individual [55] will do.

The Court: Are you challenging the fact of the payments by Mr. Schmitt?

Mr. Crouter: That is correct.

The Court: You are challenging the actual payments?

Mr. Crouter: It is a question of whether Mr. Schmitt individually made the payments, also whether it is his obligation, also whether he is paying an obligation, incurring an expense which is a legal expense.

The Court: As to the facts of payment, the record up to this point is not entirely clear. Do you expect to develop that?

Mr. Bauersfeld: Yes.

The Court: Proceed.

Q. (By Mr. Bauersfeld): Who paid \$10,375?

A. Joe L. Schmitt paid it.

Q. To whom?

A. Exact-O-Matic System, Inc., of Arizona.

Q. For what?

A. For performance by them under the terms of this contract which is Exhibit 4-D.

Q. Was the same thing true for the year 1951 in regard to the amount of \$3,020.00?

A. That is correct.

Q. With respect to the \$2,268.20 who made those payments? [56]

A. I did.

(Testimony of Joe L. Schmitt, Jr.)

Q. Why did you make those additional payments in 1950?

A. Because the corporation had expended more in the training program, much more. They were out some better than \$20,000 only having received back roughly \$10,375. Frankly, they just wouldn't stand for it.

Q. Did they do any work in addition to what they agreed to do under 4-D?

A. I used Mr. Hammett and Mr. McCowsky, two senior accountants, during the year 1950 to help train the accountant personnel of the territorial franchises in training that year. As I recall, there were eight territorial franchises in training that year.

Q. It is your position under 4-D they were not obligated to train the accountants as distinguished from the machine operators?

A. That is correct.

Q. I hand you a series of five checks and ask you to identify them.

A. These are checks I issued directly and made payable to Remington Rand in settlement of the \$2,200 some dollars item. They are my own personal checks.

Q. Did the corporation, Exact-O-Matic System, Inc., of Arizona report as ordinary \$10,375 in 1950, \$3,020 in 1951?

A. It was reported as ordinary income by the Exact-O-Matic System of Arizona. [57]

(Testimony of Joe L. Schmitt, Jr.)

Mr. Bauersfeld: May we have these marked for identification.

(Petitioner's Exhibit No. 24 was marked for identification.)

I offer as one exhibit a series of five checks totaling \$2,268.20.

Mr. Crouter: No objection.

The Court: Admitted.

(Petitioner's Exhibit No. 24 was received in evidence.)

Q. (By Mr. Bauersfeld): To operate Exact-O-Matic System, is it necessary to have accountants as well as machine operators?

A. Accountants have to set up deferred charges, figure depreciation and things of that kind Exact-O-Matic System mechanical process can't make.

Q. During the year 1951 the Government has disallowed \$2,008.87 as payments made on two rental properties. Will you explain what gave rise to them?

A. I purchased a parcel of property upon which two rental houses were then situated and in order to go in and do some of the necessary minor repairs, as I considered necessary to bring the houses up to par to maintain its rentals, I went ahead and employed certain yard men, furnished certain materials to do these repairs.

Q. Where are these houses located?

A. 8610 North Central Avenue, Phoenix.

(Testimony of Joe L. Schmitt, Jr.)

Q. I show you Petitioner's Exhibit 5-E and ask you to [58] describe the nature of the repairs.

A. Exhibit 5-E shows that during 1951 I paid for carpenter and labor in the amount of \$272.40. This covered doors, windows, putting back some of the molding that became loose. Going under the house where some of the blocks that supported the joists had become useless, leveling the floor back up, putting on new screen doors, making several screens, a small group of miscellaneous maintenance repairs. During the year 1951 I paid A. G. Hillman for labor, painting in the sum of \$250.74, plastering in the amount of \$351.50. This covered patching and things of that kind with the exception of one thing. The ceiling in the living room of the main house was patched before the plaster was finished. The patch didn't hold and fell out so we had to tear all the plaster off. Then plumbing. I paid for labor and also for the repairs of the electrical motor on the deep-well pump \$56.00.

Q. Did you buy a new motor?

A. No, I had the old one repaired, had to have it rewound, etc., five horsepower motor. I paid \$114.50 for miscellaneous labor outside, cleanup. The place was planted in oleander and things of that kind. It had been rented and the tenants didn't take good care of it. There were trees to be trimmed, brush to be pulled out, which amounted to \$114.50. The next amount was miscellaneous material including plumbing, electrical supplies, carpenter supplies, plaster,

(Testimony of Joe L. Schmitt, Jr.)

cement, [59] things of that kind amounted to \$656.33.

Then I did buy a Panelray heater. The reason was since the house was built the building code was changed and requires when you replace any rental house now in this state you must have a vent and outlet for a gas heater. I had to take out the old heater and put in one where I could put a vent in the roof.

The Court: Where is that shown?

A. Page 13.

The Court: Check No. 8706?

A. Yes. In addition, I did replace the bathtub in the main house because apparently some tenant put acid solution in it so I couldn't do anything with it. I pulled the tub out and put another one in.

The Court: Where is that?

A. Sears & Roebuck, \$87.28.

Q. (By Mr. Bauersfeld): No additions to the property? A. None of any kind.

Q. Did the repairs increase the life of the building? A. Not in my opinion.

Mr. Bauersfeld: You may inquire.

Cross-Examination

By Mr. Crouter:

Q. Let's take the last question. As I understand your statement, you said these repairs didn't increase the life of [60] the building?

A. That is correct. I said in my opinion they did not.

(Testimony of Joe L. Schmitt, Jr.)

Q. Some of the lumber was for solid supporting joists underneath the building.

A. No, in other words, the joists are supported from the walls, out in the center, by these concrete blocks around 19 to 20 inches high through the center of the support. The house was at least 20 years old. They had settled and left a space between the top of the block and the joist itself. So, as you walked in the house, you had a sway motion in some of the rooms. The carpenter had to take the pieces of wood between the upper part of the block and joist and drive a wedge in to make it solid.

Q. In how many different places in the house?

A. It would be impossible for me to crawl under there. I am too big. I know when I walked on it, it was solid after he got through.

Q. Are you talking about the large main house?

A. Yes.

Q. Now there were two houses on the same lot?

A. Yes.

Q. What was the over-all dimension of the large house?

A. Let me give it to you by rooms because I don't know. The main house had a large living room and dining room. It had what could be a den or sun room. It had a kitchen. It had a [61] glassed-in service porch. It had two bedrooms. It had a hallway and big screen porch in the front.

Q. I notice Exhibit 5-E refers to a number of lumber items. What were the major pieces of lumber used for, what did it go into in the house.

(Testimony of Joe L. Schmitt, Jr.)

A. There were only small pieces of lumber. If you are looking at the one from Finch Lumber Company, that is where I bought most of my paint, so that wasn't lumber. I think the largest amount of materials probably was paint and oils.

Q. Some of those items from the lumber company were for something besides lumber?

A. Yes.

Q. To what extent besides fixing up the floor, was lumber used on this work? You may want to examine the carpenter labor items.

A. I paid him so much an hour, for instance, hanging doors, repairing some of the screens. Some of the molding was splintered where they had driven nails into it to hang things on. We replaced that before we painted.

Q. You put in a new frame, for instance?

A. I mean this picture molding, maybe a piece four or five inches long. It had been splintered so you couldn't paint it.

Q. What about some of the plumbing items? Was any piping replaced? [62]

A. Some because in this country we have what is alkali in the water or calcium and in the course of years a white substance builds up within your pipe and cuts down the flow of your water. When we took the faucets off, we found heavy deposits so we had to take the pipe out and put in new.

Q. It would extend the life of the plumbing system, would it not?

A. If you want to say \$15.00 or \$20.00 extended

(Testimony of Joe L. Schmitt, Jr.)

the life, I will agree it probably would to that extent until it filled up again. How long it is going to take to fill up, I don't know.

Q. When a new bath tub was put in, didn't it require fixtures on the tub, too?

A. That was just your faucets. I had what you call the rough plumbing. I didn't change a bathroom from one place to another.

The Court: I suppose every repair extends the life of property to some degree. The problem here is really one of degree and I don't take seriously the witness' answer these items didn't extend the life of the property. I am satisfied it probably did. The real problem is how much, whether it is substantial or whether it is some of the things commonly regarded as capital outlay or whether expenditure of a minor character that is commonly regarded as repair. I am perfectly satisfied that these expenditures did extend the life of the property to some degree. How much is another matter. [63]

Q. (By Mr. Crouter): Mr. Schmitt, were any of these items shown by Exhibit 5-E expended on the small house? A. Oh, yes.

Q. Can you tell me whether it was mostly on the small house or how was it divided between the two houses?

A. I don't remember exactly. In other words, it was repair work. Some of the light switches were broken. In some places in the electrical outlets the plug was broken. You had to put new plugs in. A

(Testimony of Joe L. Schmitt, Jr.)

couple of places where the fixtures were broken you couldn't fix them.

Q. Will you please tell the Court even if you have to consult some of the records, the exact date you acquired the property?

A. The first part of December, 1951.

Q. You inspected the property prior thereto, I take it?

A. Not the houses inside, no, sir.

Q. When was the date you sold them?

A. I sold those houses, as I remember, the latter part of 1952 or the first part of 1953.

Q. Why did you buy them in the first place?

A. I bought those houses because they were situated on adjacent land consisting of four acres. I wanted to get rid of my citrus grove. The only way was to acquire the adjoining property so I could get the street between the two.

Q. What was the approximate purchase [64] price?

A. \$17,500 which I borrowed from the insurance company.

Q. What was the sales price of this particular property that you bought when you did sell it?

A. Of these two houses and an acre?

Q. The same land that went with it when you bought it?

A. I don't know how to answer you to be truthful because I bought four acres with houses on it. I cut an acre off the front with the two houses and

(Testimony of Joe L. Schmitt, Jr.)

took the other three acres and attached it to mine and made a subdivision.

Q. When you did sell these two houses, how much land went with the houses?

A. One short acre.

Q. What was the selling price of that approximate acre and the two houses that went with it?

A. \$12,000 or \$12,500.

Q. Did you treat this all as a capital gain proposition? A. Yes, sir, I did.

Q. Did it result in gain or loss?

A. It resulted in a slight gain the next year.

Q. When you purchased the property, had you then determined what you would do with the property—with the houses?

A. Yes, my intention was I was going to keep them for rentals because they were rentals.

Q. Were they occupied when you bought them?

A. Yes, sir. [65]

Q. Did the same tenants stay on?

A. They did until we got to repairing, painting all around inside. The people in the back house moved out because they were rather up in years and the smell of the paint bothered them but I rented it immediately after finishing repairs.

Q. I suppose you wanted to put the houses in better salable condition so you could sell the houses with the one acre along with them?

A. Mr. Crouter, if that was my intention, I would never have spent on repairs what I did. If I had in mind immediately I was going to sell them.

(Testimony of Joe L. Schmitt, Jr.)

I had no idea when I acquired those houses I was going to sell them. My purpose was to acquire them as rentals for income, take the back and add it to my acreage and sell it as a subdivision.

Q. You knew they needed repairing when you acquired them?

A. I saw the houses from the outside, knew they needed painting, which I did but I didn't know until my offer had been accepted, two or three days later when I asked the then owners to let me go through the house. That is when I found they needed repairs.

Q. Did you ever go through the inside of the houses and examine them prior to purchase?

A. No, sir, I did not.

The Court: We will have a short recess.

(Recess.) [66]

(The witness resumed the stand.)

Q. (By Mr. Crouter): Now, Mr. Schmitt, let's refer to these items with respect to the four employees. Who did they really work for in these years?

A. Exact-O-Matic Systems, Inc., of Arizona.

Q. Did they render exclusive service on the payroll of Exact-O-Matic System, Inc., of Arizona?

A. Exclusively on the payroll.

Q. I want to ask a few questions about Exhibit 4-D between you and the corporation. You may want to examine a copy of it. I notice this agree-

(Testimony of Joe L. Schmitt, Jr.)

ment particularly in Paragraphs 4, 5, and 6 on the second page provides that the Party of the Second Part, the Corporation would supervise the operations under this territorial agreement, etc. Now does that mean that it was the agreement of the corporation to supervise the training of the people who would operate the Exact-O-Matic System?

A. No, it would not specifically mean that at all. The word "supervision" means that when a territorial franchise holder, for instance, has a particular problem pertaining to a particular client on machine application on which the Exact-O-Matic System process is going to be used but, in addition thereto, some other applications may go along with it, they would be in position to be of help to assist him, etc.; in other words, pointing right back to the accounting application.

Q. You had a training system, did you not, for the [67] accountants who would subscribe to this service in the territories?

A. That is right, I did.

Q. Where was that training done?

A. Right here in Phoenix, Arizona.

Q. In what office?

A. 811 North Third Street, Phoenix, Arizona, my own individual office.

Q. How much of this corporation did you and your family own and control by stock ownership?

A. When the corporation was first organized and up until November 15, 1949, I held one share, my wife one share, and Robert Weaver held one

(Testimony of Joe L. Schmitt, Jr.)

share, the three shares being paid for by us by cash. On November 15, 1949, thirty-seven additional shares were issued to people other than my wife and myself or any members of my family. The stock was paid for in cash.

Q. How many shares were then outstanding?

A. Forty shares were then outstanding of which I had one share and my wife had one share.

Q. Did you have a position as an officer during these taxable years 1949, through 1951?

A. Up until November 15, 1949, I was an officer, my wife an officer, Mr. Weaver an officer. On November 15, 1949, Mr. Tom Deran became an officer, making the officers four.

Q. Did you continue after November 15, 1949, to be an [68] officer? A. Yes, I did.

Q. What was your position?

A. President.

Q. Referring back to the agreement 4-D, will you look at the first paragraph? Under that paragraph, as I understand it, will you please tell the Court whether you assigned over to the corporation all rights which you individually had under any registrations or applications?

Q. Are you talking about on the first page of Exhibit 4-D?

A. That is right.

Q. What paragraph?

A. Paragraph one and following with two, those two together. Will you please tell the Court

(Testimony of Joe L. Schmitt, Jr.)

whether all your rights and so forth were transferred to the Corporation by this agreement?

A. Absolutely not.

Q. Paragraph 2 on Page 1 of Exhibit 4-D starting on Page 1 where it says the company has "the exclusive right and privilege and franchise to use the registered trade name Exact-O-Matic System as its corporate name."

A. That is what I gave them, exclusive right to use it in the state of Arizona.

Q. What was your understanding as to whether you had retained anything with respect to the territorial holder [69] you had already made some territorial agreements?

A. With other territorial franchise holders other than Arizona?

Q. Yes. A. Yes, sir.

Q. Had you been able to establish the exact date in 1950 when Exhibit 4-D was signed or executed?

A. The Board of Directors of Exact-O-Matic of Arizona, Inc., ratified the agreement and signed it on the 23rd day of December, 1949.

Mr. Crouter: I call Counsel's attention to the fact it was dated 1950.

A. The agreement, when it was typed up, had it typed in here 1950. Frankly, I may not have signed it until the first part of January, 1950. That I don't remember but I do have a record, as far as the corporation is concerned, they approved it on the date I stated.

The Court: Exhibit 4-D is a photostatic copy. I

(Testimony of Joe L. Schmitt, Jr.)

ask Counsel if it is a photostatic copy of the original or if it is a photostatic copy of a copy.

Mr. Bauersfeld: It is a photostatic copy of the original.

The Court: Duplicate original?

Mr. Bauersfeld: It is a duplicate original. By that I mean carbon that was signed.

The Court: Exhibit 4-D was signed but apparently [70] there are blank spaces on the first page, as Mr. Crouter pointed out.

Mr. Crouter: I just thought he might be able to ascertain for the record more definitely when it was signed. May we pass on?

Q. Mr. Schmitt, referring to the rental matter with Remington Rand, was that agreement between Remington Rand with you individually or with the corporation?

A. I am sorry. I don't understand what you mean. Exact-O-Matic System of Arizona, Inc., were the ones that were renting the tabulation machines from Remington Rand. In the \$10,375 there was outstanding at that time obligations to Remington Rand for machine rental from Exact-O-Matic System of Arizona, Inc. In the settlement we made which was mutually agreed upon, I would pay the \$2,200 some dollars addition to the \$10,375 for the additional work they had done. So since they owed rental, I sat down and wrote my check to Remington Rand for the payment of the machines plus some \$120 for supplies.

(Testimony of Joe L. Schmitt, Jr.)

The Court: What were those machines used for, in what area?

A. These machines were used in Phoenix, Arizona.

The Court: Were they used to service clients, your clients, as distinguished from the clients of Exact-O-Matic Systems, Inc., of Arizona? [71]

A. I, myself, was not engaged in the bookkeeping business at that time. I was on tax work so these machines were used to process the bookkeeping of Exact-O-Matic System, Inc., of Arizona, and, in addition, I used the machine to train the personnel machine operators of other territorial franchise holders.

The Court: Who had the franchise for the Arizona area?

A. Frankly, there had never been a franchise granted for the Arizona area. It has always been used by Exact-O-Matic System, Inc., of Arizona but never reduced to writing.

The Court: Did you receive any kind of royalties with respect to that system in Arizona?

A. No, sir, I received no salary from the corporation, receiving no royalties, nothing.

The Court: How was it you received nothing, your interest in the corporation is apparently only one share out of 40?

A. For the simple reason that the people who are interested in it as stockholders had enough faith in Exact-O-Matic System to believe it would

(Testimony of Joe L. Schmitt, Jr.)

go over in which it was indicated it would until the time the Korean situation came about.

Q. Did the corporation have any properties of its own or operate out of your office?

A. No, it has assets of its own.

Q. What is the office address? [72]

A. 811 North Third Street, Phoenix, Arizona. Part of the building was occupied by an insurance company of Austin, Texas.

Q. Referring to the Remington Rand machines, they were in the office and used by Exact-O-Matic System, Inc., of Arizona? A. Yes.

Q. Had you guaranteed payment of rental with Remington Rand? A. I never have.

Q. With respect to the employees, had you guaranteed to them any payment of their compensation prior to that final settlement between you and the corporation? A. No, sir.

Q. Had they previously worked for you, any of those four people you named?

A. No, sir. Mr. Hammitt, Mr. McCowsky, Mr. Shepherd, Mr. Austin, when they commenced work with us were direct employees of the corporation and so hired by the corporation Exact-O-Matic Systems, Inc., of Arizona.

Q. Did I understand you to say you individually received money from the licensing out of the Exact-O-Matic System in the state of Arizona?

A. No, sir, I said I received nothing from the licensing of Exact-O-Matic System in the state of Arizona.

(Testimony of Joe L. Schmitt, Jr.)

Q. Was there anything, any system by which the corporation, the party of the second part, did have something similar [73] to the territorial agreements; in other words, was it used in Arizona?

A. It was used in Arizona but, as I previously stated——

The Court: Who got the royalties?

A. Nobody got the royalties because there were no royalties paid on the Arizona business.

The Court: Any payment of any kind made on the Arizona business? A. No, sir.

The Court: As to letting them out to any other company in Arizona?

A. No other company used.

The Court: You covered the state?

A. Not me, the corporation covered the state.

The Court: It dealt directly with clients, not with other accounts?

A. Yes, it did its bookkeeping for its clients.

The Court: You had no part of the fee which it received from those other clients?

A. That is correct, sir.

The Court: As I understand, the arrangement was uniform so the territorial holder and district holder in all states was the same?

A. That is correct.

The Court: But you yourself had a provision, as I [74] recall, in the agreement, I believe it was 1-A whereby you retained some right of designation or approval of any user such as a district holder, isn't that right?

(Testimony of Joe L. Schmitt, Jr.)

A. What paragraph are you referring to?

The Court: As it actually happened, did you pass upon such matters or did you leave such matters as the district franchise holder entirely to the territorial franchise holder?

A. The entire matter was left strictly with the territorial franchise holder. What you are referring to here is that I had the right of approval of the prospective district franchise holder insofar as the accounting ability was concerned, his integrity and financial responsibilities, that was all; in other words, I merely approved on those three things, that was all. The rest was left to the territorial man. It was his property.

The Court: With those three things, you can exercise a veto power of any license that the territorial man might wish to give to a district licensee, is not that correct?

A. That is correct, if he attempted to give to the butcher, baker or someone else, I could stop it because it has to be an accountant that could use no one else.

Q. Why did you usually have the same individual both as territorial holder and district holder?

A. That question is not clear. [75]

The Court: Why did the territorial franchise holder also have a district franchise? Why didn't he operate as a territorial franchise holder?

A. The district franchise was construed to be an operating franchise to dispense the services of Exact-O-Matic System to clients because he was a

(Testimony of Joe L. Schmitt, Jr.)

practicing public accountant. On that district franchise he paid a royalty but, by the same token, the royalty he paid as district franchise he kept half himself and remitted the other half to me. It was like paying a royalty. He put half in the right hand pocket and the other half he passed on.

The Court: One of the things I had in mind was a paragraph as shown in Exhibit 2-B at the bottom of Page 3: "The licensee covenants and agrees not to assign or transfer said license or any interest therein without the written consent of the franchise holder and approval of the patent holder." The franchise holder was your territorial holder?

A Yes.

The Court: But the patent holder was you?

A. Yes, sir.

Q. (By Mr. Crouter): As you actually operated, you closely watched this and supervised all the operations in the state, particularly with respect to any district holder?

A. If we are talking about the right to transfer, the same reason prevails here, that the district holder would [76] have to retain the right of franchise holder so it didn't get into the hands of some other person than a qualified accountant who couldn't use it.

Q. Regardless of whether it was a territorial holder or district holder under these various agreements, just the using of a process of bookkeeping, there was no physical property you actually trans-

(Testimony of Joe L. Schmitt, Jr.)

ferred over to any of these territorial district holders?

A. What do you mean by physical properties?

Q. No mechanical tangible property such as a Remington Rand machine.

A. That wiring unit is an integral part of what they got.

Q. Remington Rand manufactured it?

A. For me and I paid for it.

Q. Who would pay when a district holder in some other state such as Pennsylvania executed similar agreements to what we have here and started doing business that way? Do you mean to tell the Court you would purchase from Remington Rand the wiring mechanism that would be used by some one in Pennsylvania?

A. I will tell the Court the cost of that wiring was my expense, the rental of the other tabulation equipment which was a punch I had nothing to do with. Anybody could rent it. The Model 3 tabulator they paid for on a rental basis of \$543 some cents a month. They paid that direct to [77] Remington Rand, either as rent or on used purchase agreement or bought the machine outright but the general accountant wiring unit I paid for. That was my property. That is why we had it reduced to writing.

Q. Did you have an account directly with Remington Rand so you yourself paid for each one?

A. I wouldn't say I had an account but I mean when they were built it was shipped out. At that

(Testimony of Joe L. Schmitt, Jr.)

time I paid for the billing of the cost "260 some odd dollars, not a lot of money.

The Court: Was one of those made available to each licensee?

A. Each licensee has to have that, Your Honor, in order to complete the rental of the Exact-O-Matic process.

The Court: He couldn't sell it himself, could he?

A. No, sir.

The Court: As I recall, there was no licensee in any state that did sell it either with or without your permission?

A. No licensee ever sold it.

Q. (By Mr. Crouter): So the agreements we have stipulated covered all your dealings?

A. Yes, sir.

The Court: Let me get clear who owns those wiring units.

A. The first wiring unit went as part of the Exact-O-Matic process, the same as the manual of procedure, etc.

The Court: Who owned it, who bought it in the first [78] place?

A. Joe Schmitt. Then when he took a franchise he got that and I gave it to him and that is all, although I paid for it.

The Court: You gave it to the franchise holder?

A. I paid for the manufacturing of it because he had to have it and he paid me for the franchise, so that was part of it.

(Testimony of Joe L. Schmitt, Jr.)

Q. How many did you give to each franchise holder? A. One.

Q. So if a franchise holder had a number of district holders under him, would all the district franchise holders be served with one wiring unit?

A. Yes. He would place an order through the territorial man. He would set it on the basis of whether he wanted to buy Remington Rand equipment and would have it provided for him.

Q. Who would buy it from Remington Rand? Would you buy it? A. No.

Q. How would the district holder go about getting this wiring?

A. Let me tell you what actually happened. In other words District Franchise Holder X came in and bought it from the territorial franchise holder and paid for District Holder X the sum of \$5,000. He then in turn executed a used purchase agreement with Remington Rand to secure [79] the necessary tabulation equipment. He got the right to operate the district from the territorial man. He got a wiring unit which cost him nothing because I had paid for it when it was made.

Q. In other words, you provided the wiring unit to the district holder?

A. Right through the territorial man.

Q. Suppose you sold as you described the transaction, a territorial unit to some one in, say, State X who has no district holders under him but he can from time to time acquire district holders?

A. That is true.

(Testimony of Joe L. Schmitt, Jr.)

Q. Each time he acquires a district holder it becomes necessary to provide a wiring unit to such district holder? A. That is correct.

Q. This might occur over a period of a few weeks, over a period of months, or perhaps even years? A. That is correct.

Q. Each time a wiring unit is necessary, are you the one that provides it to the district?

A. In other words, the wiring unit is built from my own specifications.

Q. By whom?

A. By Remington Rand. In the ultimate end, I get charged for it and pay the bill for the construction, although it is shipped direct to the user because it is considered that [80] when he purchases a franchise, he makes that lump sum payment, he has paid for that as well as everything else that goes with the Exact-O-Matic System.

Q. So that every time a franchise holder acquires a new district holder, you personally through Remington Rand provide that new district holder with a wiring unit?

A. That is correct.

Q. Is there any arrangement with the district holder whereby he acquires title to this wiring unit or whether he acquires simply the right to use it, what is the arrangement with the district holder?

A. The arrangement is whatever is spelled out in his district franchise, that is part of whatever he gets from the purchase from the territorial man, if it be a district, in other words, everything he has

(Testimony of Joe L. Schmitt, Jr.)

a right title and interest to. In other words, we have made no exceptions.

Q. Is there a uniform method of arrangement with the district holders in this respect?

A. I don't say there is a uniform arrangement but a uniform pattern followed all the way through on the procedure we set up.

Q. What is that in relation to the ownership or rental or leasing or however you want to describe it, of this wiring unit?

A. The user, whether he be a district franchise holder [81] or territorial franchise holder, acquires the equipment. I am talking about the four units now that go to make up the tabulation. He either purchases it outright from Remington Rand or purchases it on what they call a use purchase plan or leasing agreement and pays a monthly rental.

Q. I am not talking about equipment from Remington Rand generally. I am talking about the wiring peculiar to the Exact-O-Matic process.

A. That order was the identical wiring unit we are referring to here, used in Exact-O-Matic System. That was ordered to be built and was built and delivered with the other tabulation equipment.

Q. It was built at your expense?

A. Built at my expense, delivered to him and eventually I was billed.

Q. Did you make it available to the district holder? Did you regard that as your machine, loaned out, so-called, to the district holder so long as he held a license?

(Testimony of Joe L. Schmitt, Jr.)

A. My understanding of it, as I said here, was under the terms of this district franchise he got from a territorial franchise holder, that was his property.

Q. Can you direct my attention to the exhibit that spells that out? You are talking about Exhibit 2-B. Will you direct my attention to the provision in that exhibit that does that? [82]

A. Down on the last part of Page 1 where it says: "The word 'patents' as used herein shall mean patents, patents pending, copyrights, registrations and any agreements, oral or otherwise, between the patent holder and Remington Rand, a Delaware corporation, heretofore or hereafter issued to Joe L. Schmitt, Jr., of Phoenix, Arizona." The oral agreement or written agreement, refers to the commitment they make that they would not manufacture, lease or sell that specific wiring unit to any person other than a licensed franchise holder.

The Court: I don't think that answers my question.

Q. (By Mr. Crouter): Mr. Schmitt, you have not shown here, as far as I recall, any payments whatever from you to Remington Rand on account of this wiring unit, have you? Is what you are trying to tell that you yourself had the idea and developed this wiring unit and it was incorporated in a Remington Rand bookkeeping machine, one of their regular machines in which they incorporated and built a machine which included your wiring unit?

A. Don't use the word bookkeeping machine

(Testimony of Joe L. Schmitt, Jr.)

because no bookkeeping machine is involved. This is tabulation equipment.

Q. Remington Rand manufactures other types of bookkeeping machines?

A. No, sir, no type of bookkeeping machine involved here. This is strictly tabulation equipment.

Q. Did Remington Rand construct a [83] tabulation machine separate and apart from anything previously invented?

A. Remington Rand created specifically from the specifications I submitted to them the wiring unit referred to here and the arrangement of the mechanisms in the printed tabulation specifically for users of the Exact-O-Matic System.

Q. Had Remington Rand prior to that manufactured any comparable accounting machine?

A. In the tabulation field you mean?

Q. Yes, sir A. No, sir, they had not.

Q. Referring to Exhibit 16, Mr. Schmitt. This is a photostat of a letter from Mr. Cooper, Supervisor of Sales Management, Controls Division of Remington Rand, the address being from Los Angeles, California, dated May 3, 1951. I call your attention to the second paragraph where it states in part: "This is to advise that we agree not to knowingly manufacture, lease or sell a tabulation wiring unit arranged with the exact specifications as wiring unit No. NB4-14055 or assign such number to any future wiring unit except for franchise holders of Exact-O-Matic," does that refresh your memory as to how that matter was handled and

(Testimony of Joe L. Schmitt, Jr.)

show Remington Rand itself really manufactured all of that and handled it under its contract with the franchise holders?

A. I don't think there is any question Remington Rand didn't manufacture or build [84] it.

Q. You had no cost of wiring unit in connection with the particular sale by Remington Rand in a way to some franchise holder in Pennsylvania, did you?

A. I did.

Q. How?

A. They charged me for construction of it.

Q. We don't have any documentary evidence on that.

A. I was never asked for any.

Q. Very well. Referring to the first agreement again, do you have that before you, Exhibit 1-A? Please turn to Page 6, Paragraph 15 in parenthesis refers to that paragraph which I would like to read: "Assignee agrees not to assign or dispose of this territorial assignment in whole or in part without the written consent of assignor." You were the assignor to that agreement as shown by the first party. Please tell the Court exactly what you retained there as far as your actual operations were concerned. In other words, how far would the territorial holders go without your permission.

A. The only limitation that Section 15 puts on the territorial assignee is just that he cannot assign it again to one who is not a qualified and competent accountant because it is wholly a tool of the accounting profession.

(Testimony of Joe L. Schmitt, Jr.)

Q. To put it another way, he didn't have complete power of disposition of it separate and apart from you?

A. I would say that he had up to that degree, full and [85] complete control over it except that he himself individually could not pass it on to someone else who couldn't possibly use it.

The Court: That isn't the way it reads. It is much broader than that. Paragraph 15 simply states the assignee agrees not to assign or dispose of this territorial assignment in whole or in part without the written consent of the assignor. As far as I can see, there are no limitations imposed upon the reasons why you would or would not give or withhold your consent. You had unlimited power to prevent his reassignment under that section.

A. I don't see it that way.

The Court: Will you direct my attention to such words or phrases in this paragraph that do limit your power?

A. I can't, Your Honor, because it states just what it states but I am going on past performance and the experience of this thing. In other words, you couldn't give it to some one who was not an accountant. I am quite certain if a pharmaceutical formula is transferred to some one it has to go into the hands of competent people to use it. It can't be scattered at will.

Q. Wasn't that because you had secured your registrations from the Government facilities, you

(Testimony of Joe L. Schmitt, Jr.)

had patent applications pending, your name was connected with it, you wanted to protect it? [86].

A. I wanted to protect the services. As you know, professional services can be good or bad, all depending on the one that renders that service. I didn't want it to fall into the hands of somebody who thought he was an accountant like one who thinks he is a lawyer, tries to practice law without knowing the law. That is the thing I was trying to protect.

Q. Do I recall your testimony correctly, when some territorial holder failed to go forward and use this system in any substantial degree, as originally contemplated, did anyone else take it over or did you designate someone else or did you just let it lapse?

A. No, sir, I never had anything presented to him where such and such was requested. Some of them failed because they split up partnerships. One of them had a fire.

Q. What happened to the wiring units?

A. They went back to Remington Rand and were put in stock until again called for to be used on another franchise.

Q. Did you get credit for them when they went back?

A. No, sir, they were carried on inventory; when released again, it was paid for. I only paid for the one.

Q. What happened the second time it was released?

A. It would be charged to me.

(Testimony of Joe L. Schmitt, Jr.)

Q. (By Mr. Crouter): Wasn't that handled entirely between your territorial holder and Remington Rand, as far as that wire unit was [87] concerned?

A. No, he set up the order but the one in charge of that you are referring to came to me.

Q. What was the approximate cost, the overall cost of a Remington Rand machine with this unit in it when a district holder, for instance, in Pennsylvania would make his contracts with Remington Rand?

A. \$543 some cents a month, \$33.00 to the U. S. Government for taxes which included \$173.45 for monthly maintenance service.

Q. Are you sure Remington Rand would sell outright and convey title to the entire machine including this unit?

A. If it were an Exact-O-Matic franchise holder?

Q. Yes. A. Yes.

Q. Were there occasions where the district holders did purchase that way?

A. Some acquired it under the used purchase plan.

Q. Did that happen and was it actually acquired, acquiring of title? A. Yes.

Q. What was the approximate overall charge of Remington Rand in such a case?

A. Including Federal tax and maintenance charges, around \$32,000. However, the machine can be bought for cash for around \$14,000 [88] to \$15,000.

(Testimony of Joe L. Schmitt, Jr.)

Q. This type of machine with the wiring unit?

A. Not the wiring unit but I mean the basic equipment can be bought from Remington Rand for that price.

Q. The \$32,000 figure was for one machine with this unit?

A. The tabulator multi control reproducing punch, the sorter and key punch on used purchase agreement which I said included Federal tax and monthly maintenance service brought the price to \$32,000.

The Court: That included acquisition of the wiring unit?

A. I paid for that \$260 some dollars. They furnished two other wiring units used for payrolls.

The Court: Suppose one of these district holders paid his \$32,000, did he acquire title to this wiring unit?

A. As far as I know he did.

The Court: He paid \$32,000 for all the other equipment of Remington Rand?

A. Yes.

The Court: Did you ever let go your hold on this wiring unit, did he acquire title, and, if so, by what means did he acquire title to this wiring unit?

A. As far as I know, he has acquired title to it. If you will pardon me, I am not an attorney. I am trying to tell you what we have done the way we proceeded.

The Court: I am trying to find what you did do.

Q. (By Mr. Crouter): It is all subject to

(Testimony of Joe L. Schmitt, Jr.)

your agreements [89] with the territorial and district holders? A. Yes.

Mr. Crouter: I have no further questions.

Redirect Examination

By Mr. Bauersfeld:

Q. Was there anything under the lease agreement with Remington Rand where, when the wiring units with the machines were sent back they were separate from the general equipment Remington Rand supplied?

A. No, the whole thing shipped back and carried there.

The Court: They were your units?

A. I paid for them. Right now I have my doubts whether they belonged to me or Remington Rand or the franchise holders at this particular point.

Q. If they were issued to some other district, there would be no further charge to you by Remington Rand because you had already paid for it once?

A. That is right because they wouldn't have to build a new one, so they wouldn't charge for it.

Q. You regarded yourself as having bought it when you made the payment the first time?

A. That is the only thing I could think of. I paid for something which I in turn gave the district franchise holder.

Q. When all the other components of Remington Rand went back to Remington Rand, this wiring unit accompanied it?

(Testimony of Joe L. Schmitt, Jr.)

A. That is right. By the same token, these district [90] franchise holders had various other wiring units they were using other than Exact-O-Matic double entry bookkeeping. They had as high as eight or ten wiring units. When the wiring units went back, all of the wiring units went back but the district franchise holder paid Remington Rand direct for the manufacturing of them.

The Court: This wiring unit was one you paid for?

A. That is right.

Q. At least, as of that time you regarded it as yours and were making it available to the district holder?

A. That is right. I figured it was something he paid the territorial man for.

Q. (By Mr. Bauersfeld): The fact is no district franchise holder gave the other equipment up, that equipment that was sent out to a district franchise holder?

A. That is right. There was never any transfer.

Q. So this never actually happened?

A. No, sir.

Q. In effect, the district franchise holder was really paying for it, the payment from a district franchise holder to territorial franchise holder, you got part of that, I think, 50%?

A. According to the territorial assignment.

Q. So, in effect, the district franchise holder was paying for it because that is what you were using to control [91] who got this from Remington Rand?

A. That is correct.

(Testimony of Joe L. Schmitt, Jr.)

Q. In fact, the district franchise holder was really paying for it?

A. That is right if you bring it around that way.

Mr. Crouter: Nothing further.

(Witness excused.)

The Court: Do you have anything further, Mr. Bauersfeld?

Mr. Bauersfeld: Nothing further.

Mr. Crouter: I would like to offer the originals of the individual income tax returns as Respondent's exhibits, Exhibit 5-E on stipulation, so that would be Exhibit F for the 1949 return, G for 1950 return.

The Court: Admitted.

(Respondent's Exhibits F and G were received in evidence.)

Mr. Crouter: The next would be the original of the 1951 return of both petitioners.

The Court: Admitted.

(Respondent's Exhibit H was received in evidence.)

Mr. Crouter: The record shows these were filed with the District of Arizona. May we have permission to substitute photostats for the benefit of all parties?

The Court: You may withdraw these exhibits for the purpose of obtaining photostats but I would prefer you [92] return the originals.

Mr. Crouter: Thank you.

The Court: Petitioner's briefs are due in 45 days; Respondent's 30 days thereafter. Petitioner may respond in 20 days.

The Clerk: Petitioner's brief, 45 days, May 10th; Respondent's 30 days thereafter, June 10th. Petitioner's, 20 days thereafter, July 1st.

(Whereupon, at 4:15 p.m. the hearing in the above-entitled petition was closed.)

Filed: April 18, 1957, T.C.U.S.

[Title of Tax Court and Cause.]

Docket No. 60267

FINDINGS OF FACT AND OPINION

Held:

1. An instrument, transferring rights to a territorial franchise holder in a bookkeeping procedure, containing provisions which in combination resulted in the retention by the transferor of substantial rights in the procedure, did not accomplish a sale or exchange within the meaning of Section 117(a), I.R.C. 1939. Nor is the transaction covered by Section 117(q).

2. Certain payments made by petitioner to or on behalf of a corporation in connection with furnishing a course of instruction and training in the use of such procedure were proper charges against petitioner's receipts from franchise holders and are deductible.

CARL F. BAUERSFELD, ESQ.,

For the Petitioners.

EARL C. CROUTER, ESQ.,

For the Respondent.

Respondent determined deficiencies in petitioners' income tax for the years 1949, 1950 and 1951 in the amounts of \$31.44, \$9,357.72 and \$2,643.40, respectively.

The issues, reduced to two by the parties, are first, whether certain transactions resulted in the sale or exchange of a capital asset, and second whether certain payments made by petitioner qualify as deductions.

Findings of Fact

Some of the facts were stipulated and are so found.

Petitioners Joe L. Schmitt, Jr. (hereinafter sometimes referred to as petitioner) and Helen M. Schmitt are, and were during the years 1949, 1950 and 1951, husband and wife. They filed joint income tax returns for those years with the then collector of internal revenue at Phoenix, Arizona.

Petitioner has engaged in accounting work since 1925. He and his wife reside in Phoenix, Arizona, and over the years his accounting work has been done in and around that city. In the course of his work he developed a procedure which converted, through the use of tabulating cards and certain

machines manufactured by Remington Rand Incorporated (hereinafter referred to as Remington Rand), single entry bookkeeping records into double entry records. Remington Rand did not manufacture these machines specifically to meet petitioner's needs. The machines were adapted to meet those needs by a wiring unit developed by petitioner, which was also manufactured by Remington Rand. He has not changed the procedure since 1947.

Petitioner named his procedure the Exact-O-Matic System. In April 1950 he applied to the United States Patent Office for the registration of two service marks and designs in connection with the Exact-O-Matic System. They were registered in December 1951.

Petitioner obtained copyrights to the following three pamphlets connected with his Exact-O-Matic System:

Title	Year of Copyright
Bookkeeping for Small Business.....	1946
Selling Exact-O-Matic System.....	1948
Exact-O-Matic System (Manual of Procedure)	1949

Petitioner made three applications for patents. Two of his applications listed his invention as a "Mechanical Method of Double Entry Bookkeeping." The third application concerned the same procedure. These applications were made in 1948, 1949 and 1952.

Remington Rand publicized petitioner's procedure. The petitioner did not solicit sales of the Exact-O-Matic System.

During the years 1949, 1950 and 1951 petitioner entered into a total of eleven substantially similar agreements (hereinafter called territorial assignments), the relevant provisions of which follow:

Territorial Assignment of Patent

* * *

Witnesseth:

In consideration of the sum of Ten Dollars (\$10.00), and other good and valuable consideration, paid to Assignor by Assignee, the parties have agreed as follows:

(1) Assignor covenants that he is the owner of the entire right, title and interest in and to those certain United States Patents, Patents pending, Registrations and Copyrights hereinafter referred to as "Exact-O-Matic System," and that he has not mortgaged, pledged, hypothecated, or otherwise encumbered the same or any right, title, or interest therein in any manner whatsoever.

(2) Assignor hereby grants unto Assignee the exclusive right, privilege and franchise to use and sell the said Exact-O-Matic System, (District, Unit A and Unit B) throughout the Territorial area described as follows:

All of the State of Oregon in addition to the counties of Cowlitz, Clark, Franklin, Walla Walla,

Columbia, and Benton of the State of Washington,¹ and to use, employ, and operate any and all methods, procedures, and processes covered by said Patents, Patents pending, Registrations, and Copyrights, within and throughout the Territorial Area, and also any reissues or extensions thereof during the entire term of said Patents, Registrations, and Copyrights, subject however, to the conditions and covenants hereinafter set forth. For the purposes of this agreement, the designation "Patent" is hereby defined to mean Patents, Patents pending, Registrations, Copyrights, and any oral or written agreement between the said "Assignor" and Remington Rand, Inc., a Delaware Corporation, heretofore or hereinafter issued to Assignor, relating to double entry machine bookkeeping methods, procedures, and processes.

(3) Assignee agrees to use their best efforts to establish and/or sell District, Unit A and Unit B franchises, throughout the Territorial area, and to that end agrees to divide the Territorial area into Districts, and to grant licenses to operate said Exact-O-Matic System in said District, upon the conditions hereinafter set forth.

Assignee agrees to create and establish district No. 1 Franchise, either in their own name or by the assignment of the District to a corporation controlled by them within thirty (30) days from the date of this agreement, such District to embrace

¹The assignments usually covered an area consisting of a single state.

the State of Oregon, Counties of Multnomah, Washington, Clackamas, Clatsop, Marion, Polk, Columbia, Yamhill, Tillamook and Lincoln, and the State of Washington, Counties of Clark and Cowlitz.

It is further understood and agreed that Assignee shall produce a minimum of sales of District Licenses, according to the following schedule:

On or before one year from the date of this Territorial Assignment, Assignee shall establish or sell a second District License, and every six months thereafter one additional District License, until a total of three District Licenses have been sold. The attached form of District License marked "Schedule A" shall be used in establishing said District Franchises.

Any sale of a District License, Unit "A" or Unit "B" License, to use said System shall be subject to approval of the Assignor, insofar as the competency and financial ability and integrity of the franchise applicant is concerned. All District License, Unit "A" and Unit "B" Licenses, shall be granted by the Assignee, subject to the conditions of that form of license marked "Schedule A, B, or C."

(4) Assignee agrees that in granting Licenses for District, Unit "A" or Unit "B" Licenses, they will use the same form of contract hereto attached (Schedule A, B, C) unless the parties hereto shall mutually agree upon a different form of contract.

The conditions of paragraph three (3) and four

(4), as above stated, are for the protection of all other Territorial Assignees and to further insure an adequate sale price to the Assignor.

(5) Assignee shall have the right to fix prices for the sale of all Licenses within their territory, but agrees not to sell any District License for less than three thousand dollars (\$3,000.00), excepting however the assignment of District No. 1 to a controlled corporation; or sell any Unit "A" or Unit "B" Licenses for less than one thousand dollars (\$1,000.00) without approval of Assignor. Assignee shall also have the right to fix the price of Exact-O-Matic service to be made by District licensees, Unit "A" and Unit "B" Licenses, to Licensees' customers for such services rendered.

(6) Assignee shall collect the sale price of each franchise granted within the territory and shall collect all royalties for the use of said Exact-O-Matic System, issued and granted by it pursuant to this agreement, and that when received it will pay to Assignor and/or his executors, administrators, and assigns, as his share of the business transacted within the territory herein described, the following:

(a) Sixty percent (60%) of the sales price of each District License, Unit "A" or Unit "B" License for said System and service, within the territory described herein; and in addition thereto:

(b) Fifty percent (50%) of the gross royalties collected from such territory by Assignee, which

royalties shall not be less than ten percent (10%) of the gross fees charged by licensees for service under said license. Assignee to retain fifty percent (50%) thereof as its share.

Assignee agrees to pay to assignor his share of sales of District, Unit "A" and Unit "B" Licenses and royalties by the fifteenth of each month for the preceding month's sales and royalties, and to accompany such payment with a detailed report of such receipts, including a duplicate of orders written for new business by the licensees within the said territory, and agrees that Assignor shall have access to the books and records of Assignee at all reasonable times for audit and examination.

(7) Assignee agrees to supervise all District, Unit "A" and Unit "B" Franchises and licenses in their territory and to use their best efforts and ability to promote and preserve the said business of each District, Unit "A" and Unit "B" licenses. Assignee further agrees to maintain a uniform type of service in conformity with the standard practice and in the manner prescribed by the methods, procedures, and process of Exact-O-Matic System, in all licensed operations within the territorial area.

* * *

(9) Assignor agrees to arrange, without any further charge, a course of instruction and to fully train and instruct at his office in Phoenix, Arizona, all personnel of Assignee required to operate the equipment, methods, and procedures as employed and used by and under Exact-O-Matic System, in

said District Number One License, provided, however, that all expenses of such personnel, including transportation to and from Phoenix, Arizona, and their living expenses during the course of training, shall be without cost to Assignor.

Assignee agrees to arrange and give a course of training and instructions to the accountant and tabulating operator in Exact-O-Matic System as outlined. Said course shall be given to the personnel of each District Franchise for a period of not less than thirty days, beginning with the personnel of the Second District Franchise.

Assignee further agrees to arrange and give a course of training and instructions to the accountant and tabulating operator in Exact-O-Matic System as outlined for the personnel of Unit "A" and Unit "B" Franchises, and shall arrange with said Franchise Holders compensation for such service rendered in training said personnel and for such other service as may be necessary in the installation of said Unit "A" and Unit "B" Franchises.

(10) Assignor agrees to use his best efforts with manufacturers of necessary equipment to procure same for use by assignee and its licensees, and agrees to procure such equipment designed and equipped with all devices necessary to process the work required under Exact-O-Matic procedure within three months of date order is accepted by Remington Rand therefor, by such Assignee or its licensees.

(12) Assignor agrees to defend at his own expense any litigation arising within or without the territorial area challenging his right to use any of the aforesaid patents to the end that all rights secured to Assignee herein may be preserved.

(13) Assignee shall select its own personnel and employees and have complete dominion and control over them, and Assignor shall have no dominion or control over any of said employees except such as may be necessary in the course of training provided for in paragraph numbered "9" of this agreement, it being the intent and purpose of this paragraph to evidence the fact that Assignee is the territorial owner of the patent, operating completely independent of Assignor. Assignee agrees to pay all taxes levied or assessed against them, including industrial or security taxes for their employees, and to file all necessary reports and returns therefor.

Whenever any license shall be granted under this Assignment, the licensee thereunder shall be the territorial owner of the patent, having complete dominion and control over his or its employees and shall accept full responsibility for all taxes levied or assessed by reason of the operation of such license and shall file all necessary returns required therefor.

* * *

(15) Assignee agrees not to assign or dispose of this Territorial Assignment in whole or in part without the written consent of Assignor.

The arrangement between petitioner and the holder of a territorial franchise (referred to as the "assignee" in the foregoing agreement) contemplated that the franchise holder, in turn, would establish a certain number of districts within his franchise area and would grant licenses covering each district. However, "District No. 1" within each franchise area was to be operated by the franchise holder himself or by a corporation controlled by such franchise holder. "Unit A" franchises were to be granted to single companies for their own bookkeeping purposes. "Unit B" franchises were to be granted to an accountant for a fixed number of customers. No Unit A or B franchise was ever issued.

Prior to November 15, 1949, petitioner, his wife and a person named Weaver each owned one share of the stock of the Exact-O-Matic Corporation (hereinafter referred to as the corporation). This corporation was incorporated in Arizona, and up until November 15, 1949, had only three shares of stock outstanding. On that day 37 additional shares were issued to new stockholders none of whom was a member of petitioner's family.

In December 1949 petitioner entered into an agreement with the corporation, the relevant provisions of which follow:

Witnesseth:

(1) Party of the First Part is the sole owner of the entire right, title and interest in and to those

certain United States Patents, Patents pending, Registrations and Copyrights referred to under that certain trade name "Exact-O-Matic System," and that he has not mortgaged, pledged, hypothecated, or otherwise encumbered the same, or any right, title, or interest therein in any manner whatsoever.

(2) Party of the First Part hereby grants unto the Party of the Second Part, subject, however, to the conditions and covenants hereinafter set forth in this agreement, and subject further to the provisions and limitations contained in the Territorial, District, Unit "A," Unit "B" and Unit "I" franchises issued or to be issued, the exclusive right, privilege and franchise to use the registered trade name Exact-O-Matic System as its corporate name, to promote the sale of Territorial franchises within and without the limits of the United States or its possessions, and to supervise the operation of said Territorial franchises already established or to be established.

(3) Party of the Second Part agrees to use its best efforts to promote and sell Territorial franchises throughout the United States and its possessions, it being understood and agreed that Party of the Second Part shall produce a minimum of sales of Territorial franchises of not less than five in any one calendar year or until all 48 States of the United States of America are sold, providing however tabulating equipment is available. In the event said tabulating equipment is not available due to

conditions beyond the control of the Party of the Second Part, then Party of the First Part shall waive this specific provision of this Agreement until such time as said equipment shall be available.

(4) Party of the Second Part agrees to use its best efforts in the supervision of those Territorial franchises already established and those territorial franchises to be established and further agrees to enforce and carry to completion the covenants and provisions contained in said Territorial franchises.

(5) Party of the Second Part agrees to arrange, without any charge, a course of instruction and to fully train and instruct the personnel of each Territorial franchise required to operate the tabulating equipment to be used in the Exact-O-Matic process in accordance with the provisions of the Territorial franchise.

* * *

(7) Party of the First Part agrees to pay to Party of the Second Part from the proceeds received from the sale of Territorial, District, Unit "A," Unit "B," and Unit "I" franchises an amount equal to:

25% of the Net Sale Price of each Territorial Franchise.

15% of the Net Sale Price of each District Franchise.

15% of the Net Sale Price of each Unit "A" Franchise.

15% of the Net Sale Price of each Unit "B" Franchise.

15% of the Net Sale Price of each Unit
“I” Franchise.

In addition to the amounts computed upon the basis of the above schedule, Party of the First Part agrees to pay to Party of the Second Part 25% of the royalties when received by Party of the First Part from the Territorial Franchise Holders, said royalty being ten percent (10%) of the gross fees for all service rendered by the Exact-O-Matic System process in all of the classifications of franchises granted.

In accordance with the provisions of the Territorial Franchise granted by Party of the First Part (Section 6-b) gross royalties are divided as follows:

Party of the First Part.....	25%
Territorial Franchise Holder.....	50%
Party of the Second Part.....	25%

(8) Party of the Second Part agrees not to assign or dispose of, mortgage, pledge, hypothecate or otherwise encumber this agreement or future proceeds therefrom in whole or in part without the written consent of the Party of the First Part.

Petitioner, both before and after November 15, 1949, was an officer of the corporation. Petitioner received neither salary nor royalties from the corporation. Petitioner, who was occupied with his own clients, did not aid the corporation in furnishing Exact-O-Matic service to its clients.

Petitioner received a letter from Remington Rand dated May 3, 1951, stating:

We have had considerable correspondence regarding the design of the wiring unit known as the General Accounting Wiring Unit # NB4-14055, which is used specifically by Exactomatic franchise holders as a set-up to enable them to use the Remington Rand Model 3 Tabulator to produce results known as "Double-Entry Bookkeeping."

This is to advise that we agree not to knowingly manufacture, lease, or sell a tabulating wiring unit arranged with the exact specifications as Wiring Unit # NB4-14055, or assign such number to any future wiring units, except for the franchise holders of Exactomatic Systems of Joe L. Schmitt, Jr.

Remington Rand charged petitioner \$260 for each wiring unit manufactured for the Exact-O-Matic System. This was so whether the Machine containing the wiring unit was rented or sold by Remington Rand. In the event it was rented the wiring unit would be returned to Remington Rand with the machine at the termination of the lease; such wiring unit belonged to petitioner, and if the machine, together with the unit, were subsequently rented, no further charge was made by Remington Rand to petitioner for the unit.

Petitioner has never applied for a copyright, trademark or patent other than in connection with the Exact-O-Matic System.

Notwithstanding the first above quoted paragraph of the territorial assignment (concerning the \$10 consideration) petitioner received the following net

amounts² in connection with the 11 territorial assignments entered into during the years in question:

1949	\$ 7,962.02
1950	36,992.00
1951	10,997.00

Additionally, in accordance with section 6(a) of the territorial assignments, petitioner received the following net amounts:

1949	\$ 0.00
1950	7,498.00
1951	1,799.00

Petitioner treated the net amounts received in accordance with section 6(a) and the net amounts received in place of the above-mentioned \$10 as gains from the sale or exchange of a capital asset. Respondent determined that these payments were ordinary income.

Amounts received by petitioner in accordance with section 6(b) of the territorial assignments were treated by him as ordinary income.

During the year 1949 petitioner personally carried out the obligations imposed on him by paragraph (9) of the territorial assignment.

During 1950 and 1951 "personnel" sent to Phoenix by territorial assignees to study the Exact-O-Matic System were trained by the corporation to

²"Net amounts" as here used mean total amounts received less certain uncontested offsets made in connection therewith.

operate the necessary machines and were given instruction in the use of the system.

Petitioner made payments to the corporation totaling \$10,375 in 1950 and \$3,020 in 1951. These amounts were calculated in accordance with their agreement. The corporation reported these payments on its income tax returns as ordinary income. Petitioner, in the course of computing his "long term gain" resulting from the territorial assignments treated these amounts as "expense(s) of sale" and reduced the amounts he received as a result of the territorial assignments accordingly. Respondent refused to allow any reduction in respect of the amounts thus paid to the corporation.

The management of the corporation felt that it had expended more money in 1950 on its training program than it had received under section (7) of its agreement with petitioner, and that it had rendered some training services on petitioner's behalf that were beyond those required of it by the agreement. Petitioner, in that year, issued personal checks, payable to Remington Rand in the total amount of \$2,268.20. These checks were in payment of amounts owed Remington Rand by the corporation in connection with machine rentals and the purchase of office supplies, and were issued by petitioner in recognition of a possible claim against him by the corporation. Petitioner treated the total amount of these checks as an expense incurred in his business and deducted it accordingly. Respondent disallowed the deduction.

Opinion

Raum, Judge:

1. Petitioner Joe L. Schmitt, Jr., had developed a process, utilizing tabulating cards, to convert ordinary single-entry bookkeeping data into double-entry bookkeeping records. He named the process the Exact-O-Matic System. The system was operated by use of standard Remington Rand mechanical equipment, as modified by a wiring unit designed by petitioner which was also manufactured by Remington Rand but which it had agreed not to sell or lease to anyone other than a franchise holder of the system. The system was intended for use by accountants in providing service for small businesses. Petitioner has applied for several patents and has obtained certain trade or service marks in connection with the system; also he has obtained copyrights of several pamphlets relating to the system.

During the years 1949-1951, he entered into eleven agreements, in each of which he granted to the other contracting party, referred to as the assignee or territorial franchise holder, a franchise with respect to the system throughout a specified area. In general, each such area covered a State, and it was petitioner's purpose to continue to issue similar franchises throughout the United States. The plan contemplated further that each territory would be divided into districts, and that the territorial franchise holder would, in turn, issue licenses for use of the system, presumably by accountants, for each

such district.³ Moreover, petitioner required each franchise holder, either alone or through a controlled corporation, to operate the system in one of those districts, referred to as "District No. 1."

In connection with the creation of each territorial franchise petitioner received a lump sum. Also, upon the issuance of licenses by the territorial franchise holder, a lump sum (referred to as the "sales price") was payable by the licensee to the territorial holder, and, pursuant to section 6(a) of the territorial franchise, 60 per cent of that lump sum was payable to petitioner. In addition, each licensee was required to pay royalties (which were to be not less than 10 per cent of the gross fees charged by the licensee for service under the license) to the franchise holder, and, pursuant to section 6(b) of the territorial franchise, the franchise holder, in turn, was required to pay 50 per cent of such royalties to petitioner.

We are called upon to decide whether the lump sums paid to petitioner directly in connection with the issuance of the territorial franchises and that portion of the lump sums collected from the licensees and paid over to him pursuant to section 6(a) of the territorial franchise agreements are to be treated as the proceeds from a "sale or exchange of a capital asset" under Section 117(a)(4), In-

³In addition to "District" licenses, the agreements also provide for the issuance of certain other licenses referred to as "Unit A" and "Unit B," but no such other licenses were ever issued.

ternal Revenue Code of 1939. Cf. also Section 117(q) of the Code, added by the Act of June 29, 1956, c. 464, 70 Stat. 404. Petitioners reported such amounts as long-term capital gains on their returns, and the correctness of the Commissioner's determination that they represented ordinary income is the principal issue before us. Petitioners reported their portion of the royalties received under section 6(b) of the territorial franchise agreements as ordinary income, and no question is here presented as to such royalties.

Petitioner contends that each of the agreements with the eleven territorial franchise holders resulted in a "sale or exchange of all his substantial rights in the Exact-O-Matic System to the territorial franchise holder, and that therefore the consideration received by him must be treated as the proceeds of a sale under Section 117, entitled to the preferred treatment accorded to capital gains under the Code. At the outset, it may be observed that his position is not consistent as to all of the consideration received, for, as noted above, the so-called section 6(b) royalties were reported as ordinary income and they are not in controversy herein. If the transactions were in fact sales then all the consideration received, whether denominated as "sales price" or as "royalties" would be regarded as proceeds of the sales. See *Rose Marie Reid*, 26 T.C. 622, 632.

Whether petitioner in fact transferred all of his substantial rights in the Exact-O-Matic System

within the area of each territorial franchise depends upon an appraisal of all of the evidence, particularly of the arrangements between petitioner and the territorial franchise holders. Referring to a transfer of patent rights in *Rose Marie Reid*, *supra*, we said (p. 632):

Nor is the question governed by the use of particular words of art. The transaction suffices as a sale or exchange if it appears from the agreement and surrounding circumstances that the parties intended that the patentee surrender all of his rights in and to the invention throughout the United States or some part thereof, and that, irrespective of imperfections in draftsmanship or the peculiar words used, such surrender did occur. * * *

Cf. *Watkins v. United States*, F. 2d (C.A. 2, February 26, 1958). It is our conclusion, after a careful study of the entire record in the present case, that petitioner retained, in the aggregate, such continuing rights and interest in the system as to preclude reorganizing these transactions as sales.

An examination of the territorial assignment or franchise and the form of license or district franchise which the territorial holder was required to use in granting a district license amply discloses the broad range of rights, powers, and interests reserved by petitioner as well as the substantial limitations imposed upon the rights assigned to the territorial franchise holder, or assignee.

(a) The assignee agreed not to assign or dispose of his territorial franchise in whole or in part without petitioner's written consent. The veto power thus retained by petitioner upon disposition of the territorial franchise by the alleged purchaser from petitioner is completely without restriction. Petitioner retained the unlimited power to forbid or permit any sale or assignment of the territorial franchise holder's rights. Such sweeping control over one of the most important aspects of property ownership—the right to sell or dispose—is hardly consonant with the position that petitioner had sold all of his substantial rights in the system within the area of the territorial franchise.

(b) Petitioner's continuing interest is further shown by the territorial franchise holder's contractual undertaking to divide the franchise area into districts and to grant licenses upon conditions agreed to between the territorial franchise holder and petitioner.

(c) The territorial franchise holder was required to agree to establish "District No. 1," defined to embrace specified portions of the franchise area, in his own name or by assignment of the District to a controlled corporation within 30 days.

(d) The territorial franchise holder contracted to produce a minimum of sales of district licenses, according to a specified schedule.

(e) Any sale of a license by the territorial franchise holder was required to have petitioner's ap-

proval as to the competency, financial ability, and integrity of the applicant for the license, and the licenses themselves were to be subject to conditions contained in a specified form of license. The record before us does not contain that form, but there is in the record the actual license that was issued in the case of one District. Since the burden of proof is upon the petitioners, we must assume that the conditions in the form were no less onerous than those contained in the license itself, or that the parties had not meanwhile agreed upon a different form. Among such conditions were the following:

(i) Comprehensive provisions for the payment of royalties based upon a percentage of gross fees charged by the licensee, as well as provision for rendering monthly reports.

(ii) Provisions for making available licensee's books and records to the territorial franchise holder and petitioner.

(iii) Provisions granting territorial franchise holder the right to inspect and supervise the licensee's operation of the system to determine that service is being rendered in accordance with the standard practice and prescribed method.

(iv) Licensee's undertaking not to assign or transfer the license without the written consent of the territorial franchise holder "and approval of Patent owner."

(v) Upon death of licensee, his interest must pass to his estate, "and upon proper showing" to

the territorial franchise holder and petitioner, the license may be disposed of "to competent parties who are qualified to conduct the business of said district licensee subject to approval by Franchise Holder and Patent Owner."

(f) The territorial franchise holder could not sell licenses for less than specified minimum prices.

(g) In the issuance of licenses, the territorial franchise holder was forbidden to provide for royalties that would be less than 10 per cent of the fees charged by the licensee.

(h) The territorial franchise holder agreed to furnish petitioner with detailed monthly reports of sales and royalties, "including a duplicate of orders written for new business by the licensees."

(i) Books and records of territorial franchise holder were to be open to petitioner for audit and examination at all reasonable times.

(j) The territorial franchise holder was required to agree to supervise licenses, and to use best efforts to promote and preserve the business of each district and license; also, to maintain a uniform type of service in prescribed manner in all licensed operations within the territorial area.

(k) Petitioner reserved the right to terminate the franchise upon the holder's failure to make required payments of petitioner's share of sales and royalties.

(l) Petitioner obligated himself to furnish a course of instruction and training to "all personnel" of the territorial franchise holder "required to operate the equipment, method and procedures" of the Exact-O-Matic System; and, at the same time, he required the territorial franchise holder to give similar courses of instruction and training to licensees.

(m) Petitioner obligated himself to use his best efforts with manufacturers to obtain necessary equipment for use by the territorial franchise holders and licensees, and undertook to procure such equipment within three months of the acceptance of the order by Remington Rand.

(n) Petitioner agreed to furnish all sample forms "now or hereafter in use under Exact-O-Matic procedure." (Emphasis supplied.)

(o) Petitioner agreed to defend at his own expense any litigation challenging his "right to use any of the aforesaid patents."

We are of the opinion that the foregoing aspects of petitioner's relationship to the territorial franchise holder and the franchise itself are inconsistent with the position that he had disposed of all his substantial rights in the Exact-O-Matic System within each territorial area. It is important to note that we do not rest our conclusion upon any one of petitioner's retained interests or powers, and, without doubt, there are cases in which the reservation of some similar powers and rights has been held not to be fatal. We hold that all of the rights, powers, and

continuing interests reserved by petitioner, taken in combination, are of such character as to be inconsistent with a "sale or exchange" of property by petitioner, and that Congress did not intend to confer the special benefits relating to sales of capital assets in such situations. It is no answer to say that a number of the rights reserved by petitioner were merely to protect his interest in the system or to insure full payment for the assignments. That reason may explain why such reservations were made, but it does not detract from the conclusion that petitioner did not in fact dispose of all his substantial interest in the system by reason of such reserved rights when taken together with all other reserved rights, powers, and interests.

Section 117(q) of the Code, added by the Act of June 29, 1956, c. 464, 70 Stat. 404, referred to by petitioners, does not strengthen their position. Not only is it limited to transfers of patent rights, but it deals with transfers "of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights." Our conclusion that the transfers herein (which involved far more than patent rights) were not made with respect to "all substantial rights" in the Exact-O-Matic System renders these new provisions inapplicable.

2. In their returns for 1950 and 1951 petitioners reduced the amounts received under the territorial franchises by \$11,375 and \$3,020, respectively, as "expense of sale." The Commissioner refused to al-

low \$10,375 of the reduction for 1950 and the entire \$3,020 reduction for 1951. These represent the net amounts paid by petitioner to the corporation, in accordance with their contract, for giving instruction and training to "personnel" of the territorial franchise holders. Petitioner was obligated to furnish such instruction and training, and we think it plain that his payments to the corporation for carrying out that obligation on his behalf were a proper charge against the amounts received from the franchise holders. We hold that they are deductible.

In addition, a question had arisen between petitioner and the corporation with respect to some training of accountants by the corporation that may have gone beyond the strict requirements of the contract between petitioner and the corporation. The corporation claimed that it was losing money on the entire arrangement, and the matter was settled by petitioner's payment of certain bills which the corporation owed to Remington Rand. These payments were made in 1950 and were in the aggregate amount of \$2,268.20. We hold that this amount is similarly a proper charge against petitioner's receipts and is likewise deductible.

3. A final issue relating to the deductibility of certain expenditures with respect to rental properties has been conceded by the Government on brief.

Decision will be entered under Rule 50.

Served: May 20, 1958.

The Tax Court of the United States

Washington

Docket No. 60267

JOE L. SCHMITT, JR., and HELEN M.
SCHMITT,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Findings of Fact and Opinion filed herein May 20, 1958, directing that decision be entered under Rule 50, the parties, on July 22, 1958, filed an agreed computation for entry of decision. It is therefore

Ordered and Decided: That there are deficiencies in income tax for the years 1949, 1950 and 1951 in the following amounts:

Year	Deficiency
1949	\$ 31.44
1950	4,382.06
1951	1,166.48

[Seal] /s/ ARNOLD RAUM,
 Judge.

Entered: August 4, 1958.
Served: August 4, 1958.

In the United States Court of Appeals for the
Ninth Circuit

Tax Court Docket No. 60627

JOE L. SCHMITT, JR., and HELEN M.
SCHMITT,

Petitioners on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

PETITION FOR REVIEW

Come now Joe L. Schmitt, Jr., and Helen M. Schmitt, petitioners on review by their attorney, Robert Ash, and respectfully show:

I.

Jurisdiction

Petitioners on review are Joe L. Schmitt, Jr., and Helen M. Schmitt, husband and wife, whose address is 8540 North Central Avenue, Phoenix, Arizona. Petitioners on review filed Federal income tax returns for the taxable years 1949 to 1951, inclusive, with the Collector of Internal Revenue for the District of Arizona at Phoenix, Arizona, which is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit wherein this review is sought.

Respondent on review (hereinafter referred to as "Commissioner") is the duly appointed, qualified and acting Commissioner of Internal Revenue appointed and holding his office by virtue of the laws of the United States.

This petition for review is filed pursuant to the provisions of §§ 1141 and 1142 of the Internal Revenue Code of 1939 and §§ 7482 and 7483 of the Internal Revenue Code of 1954.

II.

Prior Proceedings

On September 2, 1955, the Commissioner of Internal Revenue sent to the petitioners by registered mail a notice of deficiency in which he determined that the petitioners owed a deficiency in income tax for the taxable years 1949 to 1951, inclusive, in the total amount of \$12,032.56.

Thereafter the petitioners duly filed an appeal from said determination with the Tax Court of the United States. The case was tried before the Honorable Arnold Raum, Judge of the Tax Court of the United States, on March 25, 1957, in Phoenix, Arizona. On May 20, 1958, the Tax Court promulgated its findings of fact and opinion written by Judge Raum. On August 4, 1958, the Tax Court entered its decision ordering and deciding that the petitioners owed deficiencies in income tax for the taxable years 1949 to 1951, inclusive, as follows:

Year	Deficiency
1949	\$ 31.44
1950	4,382.06
1951	1,166.48

Petitioners on review petition the United States Court of Appeals for the Ninth Circuit to review the order and decision entered by the Tax Court of the United States on August 4, 1958, wherein and whereby it was ordered and decided that there is a deficiency in income tax for the years 1949 to 1951, inclusive, in the amounts as follows:

Year	Deficiency
1949	\$ 31.44
1950	4,382.06
1951	1,166.48

III.

Nature of the Controversy

Petitioner Joe L. Schmitt, Jr., (hereinafter referred to as "petitioner") and Helen M. Schmitt are and were during the years 1949, 1950, and 1951, husband and wife. They filed joint income tax returns for those years with the Collector of Internal Revenue at Phoenix, Arizona.

Petitioner Joe L. Schmitt, Jr., had developed a process utilizing tabulating cards to convert ordinary single-entry bookkeeping data into double-entry bookkeeping records. He named the process the "Exact-O-Matic System." The system was operated by use of standard Remington Rand me-

chanical equipment, as modified by a wiring unit designed by petitioner, which was also manufactured by Remington Rand but which it had agreed not to lease or sell to anyone other than a franchised holder of the system. The system was intended for use by accountants in providing service for small businesses. Petitioner had applied for several patents and has obtained certain trade or service marks in connection with the system. Also, he has obtained copyrights of several pamphlets relating to the system.

During the years 1949-1951, inclusive, petitioner entered into eleven agreements whereby he granted to the assignees the exclusive right, privilege, and franchise to use and sell the Exact-O-Matic System throughout a designated or specified territorial area. These agreements are entitled "Territorial Assignment of Patent." By these agreements, the petitioner assigned all of his rights in the trade or service mark, name, patents, and patent applications in perpetuity to the assignee with no provision for reversion except for nonpayment of the consideration set forth in the agreement.

In consideration for said assignments, the assignees paid petitioner during the years 1949, 1950, and 1951, lump sum payments in the amount of \$7,965.02, \$38,000.00, and \$11,000.00, respectively. In addition, during the years 1950 and 1951, as part of the purchase price for the rights granted under the territorial assignments, petitioner received from the territorial assignees, the sums of \$7,500.00 and

\$1,800.00, respectively, for the licensing by the territorial assignees of "District Franchises" within their territorial area. The petitioners reported the proceeds from the sale or assignment of the "Territorial Assignment of Patent" to the eleven assignees as gain from the sale of a capital asset. The Commissioner of Internal Revenue and the Tax Court held that the gain resulting from the sale or assignment was taxable as ordinary income. The question presented by this appeal is whether the proceeds received by petitioner from the sale or assignments of "Territorial Assignment of Patent" to the assignees during the years 1949, 1950, and 1951, is taxable as ordinary income or as capital gain.

/s/ ROBERT ASH,

Attorney for Petitioners on
Review.

Received and Filed October 24, 1958, T.C.U.S.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 24, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review" (including exhibits 1-A through 5-E attached to the stipulation of facts, but excepting the remainder of the exhibits which were

admitted in evidence which are separately certified and transmitted herewith) in the case before the Tax Court of the United States docketed at the above number and in which the petitioners in the Tax Court have filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 24th day of November, 1958.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

[Endorsed]: No. 16431. United States Court of Appeals for the Ninth Circuit. Joe L. Schmitt, Jr., and Helen M. Schmitt, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of the Tax Court of the United States.

Filed: January 19, 1959.

Docketed: January 29, 1959.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

[Title of Court of Appeals and Cause.]

STATEMENT OF POINTS

The points on which petitioners intend to rely in this appeal from the Opinion and Final Order entered by the Tax Court of the United States are:

1. The Tax Court of the United States erred in determining that there are deficiencies in income tax for the years 1949, 1950, 1951 in the amounts of \$31.44, \$4,382.06, \$1,166.48, respectively.

2. The Tax Court of the United States erred in holding and deciding that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as ordinary income instead of at capital gains rates.

3. The Tax Court of the United States erred in failing to hold that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as the sale of a capital asset.

4. The Tax Court of the United States erred in failing to hold that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as a sale of exchange of a capital asset under Section 117(a) of the Internal Revenue Code of 1939.

5. The Tax Court of the United States erred in failing to hold that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as a sale or exchange of a capital asset under Section 117(q) of the Internal Revenue Code of 1939, added by the Act of June 29, 1956, c. 464, 70 stat. 404.

6. The Tax Court of the United States erred in holding that petitioner retained in the aggregate such continuing rights and interest in the Exact-O-Matic System as to preclude recognizing the sales or assignments as sales.

7. The Tax Court's Opinion and Decision are not supported by the evidence.

8. The Tax Court's Opinion and Decision are contrary to law.

Respectfully submitted,

/s/ ROBERT ASH,

Attorney for Petitioners on
Review.

Service of copy acknowledged.

[Endorsed]: Filed January 29, 1959, U.S.C.A.

